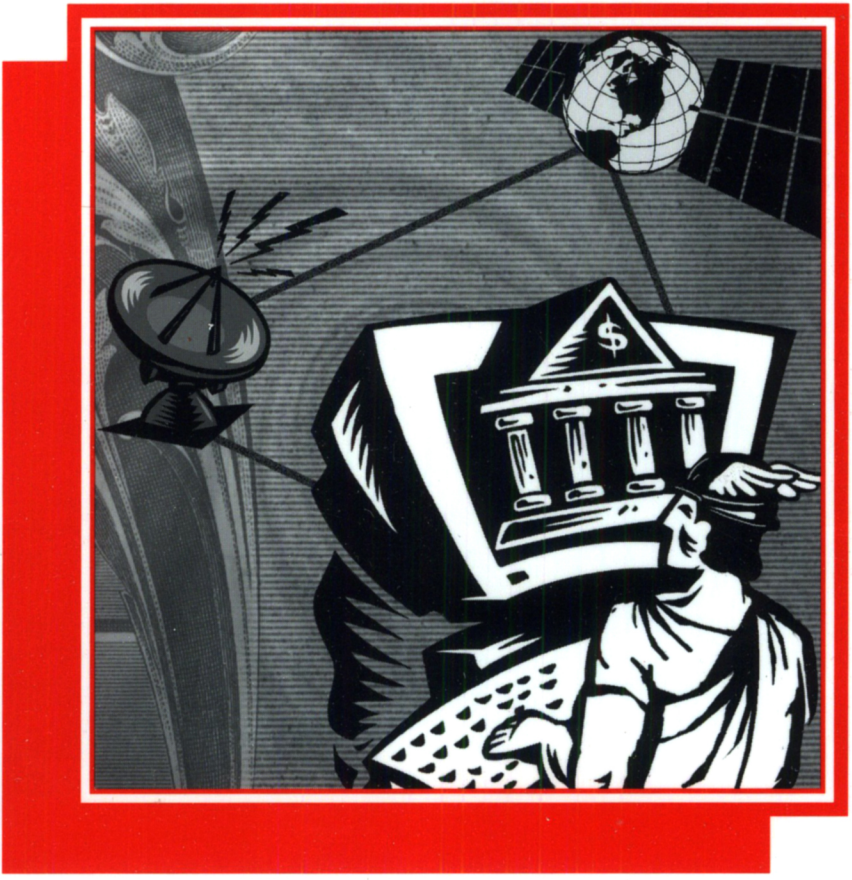
Current Legal Issues Affecting Central Banks



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Introduction

It is now generally accepted that a central bank has a duty to oversee the payment systems of a country. This responsibility is expressly recognized by the Maastricht Treaty, which lists among the four basic tasks of a central bank that is a member of the European System of Central Banks the promotion of the "smooth operation of payment systems."[1] Increasingly, the responsibility is finding expression in modern central bank legislation, not only in the European Community but elsewhere as well. While the concept of payment of an obligation is fundamental in law and commercial practice, its origin is shrouded in antiquity. Nevertheless, as the millennium draws to a close, the development of new methods of making payments (each with its legal framework) is accelerating. In what follows, several major payment systems will be considered.

Legal Aspects of Payment Systems[2]

Means of Payment

Payment is effected by the transfer of money from debtor to creditor. Legal tender statutes exist in order to provide legal sanction for this method of payment. In accordance with such statutes, if the debtor tenders the kind of money (*cash*) specified by the law, the creditor will be bound to accept it in discharge of an obligation. The rules of transfer for cash are intended to maximize the quality of transferability even at the expense of the true owner. Thus, in the jurisdiction of some countries, if cash is stolen by a thief, the owner from whom it was stolen cannot recover it from a third party who has received it fairly and honestly in payment for value. In such countries, if cash is lost, the owner who has lost it may not recover it from an innocent finder after the latter has honestly paid it away. The parties to a transaction may, however, agree to use another method of payment. As the twentieth century draws to a close, a number of cashless means of payment are in use.

In many countries the *check* is the most commonly used cashless means of payment. A check is a type of negotiable instrument, specifically, a demand order drawn on a bank. The distinguishing feature of negotiability is the facility with which it may pass ownership of the instrument and the attendant right to payment from one party to the next transferee. Under certain circumstances, the transferee of a negotiable instrument may be protected from defects in his chain of title or other defenses of a prior party

that, in the absence of the quality of negotiability, would jeopardize the ability of the transferee to obtain payment on the instrument. The law governing negotiable instruments around the world is basically divided into two schools. One school, comprising the civil law countries of Europe and many other countries whose law derives therefrom, has adopted the Geneva Conventions that were agreed upon in the 1930s.[3] The second school, comprising the common law countries of the United Kingdom, the United States, and countries whose law derives from them, bases its law on the Bills of Exchange Act of 1882, the Uniform Commercial Code (UCC), and similar legislation. Legislation specially addressing checks (as differentiated from other kinds of negotiable instruments) is not uncommon.

In a number of countries, *giro* systems of payment have developed. Sometimes these systems are administered by the post office, but banks (notably the savings banks) have often developed their own giro systems. In these systems, a payor may direct his bank to make payment into the account of his payee either at the same bank or, if the payee maintains his account at a different bank, at the payee's bank. The account of the payor is then debited and that of the payee is credited. This type of system, in some countries, accounts for a greater proportion of consumer payments than the check.

Payment by means of a *card* has developed rapidly in many countries. The card may be a *debit* card that is used by a consumer at the point of sale to make a purchase. Typically, a bank may place terminals in stores that enable the consumer to pay the merchant through the use of an encoded debit card that debits the consumer's account at his bank and credits that of the merchant. *Credit* card systems have also evolved, and in many countries their use exceeds that of debit cards. They allow consumers to make payment by way of credit extended by a merchant or a financial institution. Both debit and credit cards may also allow the withdrawal of cash at an automated teller machine. Conceptually, both may involve three parties (consumer, merchant, and bank) or two parties (consumer and merchant). In practice, there may be additional parties. Thus, a system may be composed of a bank that issues a card to the consumer (issuing bank), another bank that has sought out merchants to enroll in the system (merchants' bank), and a credit card organization to process the transactions. In most countries, the relationships between these parties are governed by agreements. In the United States, specific legislation has been enacted to provide a statutory framework.

Analytical Framework of Cashless Payment Systems

Cashless payment systems involving the use of the means of payment previously described can be divided conceptually into two classes in

accordance with the types of transfers that they handle. There are systems that use debit transfers and those that use credit transfers. In a debit transfer, the payment instruction and funds may move in opposite directions while in a credit transfer, the payment instruction and funds move in the same direction. Another way of visualizing the two types of transfers is that in a debit transfer the funds are pulled through the system by the payee, while in a credit transfer the funds are pushed through the system by the payor.

Debit Transfers

In a debit transfer, the payee instructs his bank to collect money from the payor. The check is a familiar form of debit transfer. In a typical check transaction, a payor, the drawer, sends his check to the payee. The payee deposits the check in his bank account for collection. The check is conveyed through the collection process, which may involve one or more intermediary banks, and is then presented for payment at the drawee bank. The payee may receive credit according to a timetable that allows the check sufficient time to clear. The final step in this process is the debiting of the drawer's account by the drawee bank. (In this system, float is built in, to the advantage of the payor, whose account is debited only at the end of the process.) It may be noted that in the check scenario, the payment instruction moved from the payee to the drawee bank while payment moved in the opposite direction. In effect, the payee pulled the funds through the system. Debit transfers may also be electronic and in this form are familiar in the consumer transactions that are effected through automatic clearinghouses or by debit cards.

Credit Transfers

In a credit transfer, the payor instructs his bank to debit his account and to cause the account of the payee, at the same bank or another, to be credited. Accordingly, the first step may involve a debit to the payor's account. Cash may substitute at either end of the transaction if either the payor or payee lacks a bank account. The credit transfer is familiar to those from countries in which the postal service or savings banks have long operated giro systems.[4] In these systems, the payor pushes the funds through to the payee or his bank. The funds and the payment instruction move in the same direction.

Credit transfers may be simpler than debit transfers involving a check that is based on the movement of a negotiable instrument in paper form. Credit transfers are particularly well suited to an electronic means of communication, whether by telegraph, telex, or similar means. In their electronic form, they are familiar as wire transfers. They are less subject to

error and fraud than the traditional check, and perhaps as a consequence, the law of credit transfers is generally both less complicated and less developed. It should be noted that credit transfer systems, especially retail ones, can be designed intentionally to incorporate float for the benefit of the payor.

As the economic systems of countries develop and mature, there is often an increased role for cashless means of payment. Cash transfers, however, may remain popular for a number of reasons. One reason, by way of example, involves the increasing use of automatic vending machines and related items. Another reason relates to the difficulties in tracing cash payments—difficulties that segments of a population may prefer in order to evade taxes or for other purposes. Both paper-based and electronic systems are, nevertheless, becoming common throughout the world. Electronic funds transfers (EFTs), in particular, are being used both in domestic and in international transactions. They may be used in retail consumer transactions or in wholesale movement of funds between financial institutions.

Consumer EFTs and Applicable Rules[5]

Types of Consumer Transactions in the United States

In the United States, consumer transactions (those initiated by, as well as those affecting, consumers) include, among other things, transfers (i) at point of sale, (ii) by automated teller machines, and (iii) through automated clearinghouses.

1. *Point of sale* (POS) terminal devices have been introduced in some retail stores. They are connected to the computer of a bank where transactions are immediately effected. Typically, they are used to transfer funds from the purchaser's bank account to that of the merchant. They may perform other functions as well, such as verifying and guaranteeing checks.

2. *Automated teller machines* (ATMs) may be located on or off a bank's premises, for example, at commercial shopping centers. They may be used to dispense cash, accept deposits and loan payments, provide balance information, and similar functions. The machines are activated by the insertion of a plastic card and the entry of a personal identification number (PIN).[6]

3. *Automated clearinghouses* are computerized facilities organized by banks to handle many of the high-volume, low-value transactions that have traditionally been effected through checks. Transfer instructions on

magnetic tape or disks containing many such transactions in the form of batched entries are delivered by banks to the facility. Alternatively, the data may be transmitted directly to the facility by wire. The data may include credit or debit entries. Credits entered directly into a consumer's bank account may include payroll, pension, social security payments, and the like. Debit entries have generally included preauthorized, recurring payments, such as mortgage and other loan obligations and insurance premiums. Although traditionally encompassing low-value consumer transfers, more recently corporate payments have been assuming an increasing importance. The various regional automated clearinghouses are linked into a national network through the Federal Reserve System.

The Truth in Lending Act and The Electronic Fund Transfer Act of 1978

Although states in the United States have enacted laws applicable to electronic funds transfers, federal statutes preempt them to the extent that they are inconsistent. There are two such statutes.

Credit cards are addressed in The Truth in Lending Act, as amended,[7] and Regulation Z issued by the Federal Reserve.[8] This law governs only the relations between the card issuer and the cardholder, and even then it covers only selected issues, leaving the remainder to be governed by the agreement between the card issuer and the cardholder. The relations between the merchant and his bank and between the card issuer and that bank are left for the agreements between the parties. Among the matters that are governed by the statute is the liability of the cardholder for unauthorized charges. The rule adopted is that he is liable for the lesser of (i) $50 or (ii) the amount obtained through the unauthorized use. This rule applies to amounts charged on the card before the cardholder notifies his bank (the card issuer) that his card has been lost or stolen. He has no liability for charges incurred thereafter.[9] In the event of a dispute between the cardholder and the merchant, the cardholder may withhold payment of the relevant charge on his credit card bill if he has made a good faith attempt to resolve the dispute and complied with certain other conditions.[10] The rules also impose obligations on the card issuer when the cardholder notifies it of a billing error. If the issuer does not correct the error and credit the cardholder's account accordingly, it must conduct a reasonable investigation before it may conclude that no billing error occurred and must then explain to the cardholder how it reached this determination.[11] If the cardholder remains dissatisfied with this resolution, he may sue the issuer in court. Rules also prohibit a card issuer from issuing a credit card except in response to a request or application for a card.[12] Furthermore, a card issuer has certain preissuance disclosure obligations that include providing information on the interest rate and how

to compute finance charges, what other fees apply, whether there is a grace period for payment, and other matters.[13]

Debit cards are addressed in the Electronic Fund Transfer Act of 1978[14] and in Regulation E of the Federal Reserve. The Act is intended to function as a consumer protection law for point of sale transfers, automated teller machine transfers, transfers initiated by telephone and direct deposits, or withdrawals of funds. Transfers through an automated clearinghouse are also covered. Transfers originated by checks or other paper instruments are excluded. The statute relies heavily on the principle of disclosure. Accordingly, it requires a financial institution (which is broadly construed) providing facilities for such transfers to disclose to consumers information concerning their rights and liabilities, with documentation of their transactions and with procedures to correct errors and resolve disputes. It further sets out the responsibility of the provider to make transfers in a correct amount and in a timely manner, in accordance with the consumer's instructions, and to stop payment of a preauthorized transfer if so requested by him. Unexcused failure of a financial institution to carry out such responsibility subjects it to liability for all damages proximately caused to the consumer. The consumer's liability in the case of an unauthorized transfer is circumscribed if he observes certain requirements. Such liability may not exceed the lesser of the actual loss or $50, if the financial institution is notified within two business days of the consumer's discovery of the loss or theft of his plastic card. Thereafter, the limitation rises to $500, but failure to notify the financial institution within 60 days after the transmittal to him of its periodic statement removes all limitation on liability for unauthorized transactions.

The statute restricts the ability of financial institutions to issue access devices (e.g., debit cards) to consumers who have not requested them.[15] The rules also require disclosure of charges and other information before the device is issued,[16] as well as receipts when it is used,[17] and periodic statements.[18] There is no right for a consumer to reverse an electronic fund transfer (other than to stop payment of a preauthorized transfer).[19] Procedures are set out that govern the resolution of errors.[20]

Neither the Electronic Fund Transfer Act nor the implementing Regulation E promulgated by the Federal Reserve applies to wholesale transfers of funds between financial institutions. Both are limited to transfers for consumers who are natural persons.[21] Moreover, such transfers are outside the scope of The Truth in Lending Act and its implementing Regulation Z.

European Community Experience

The European Community has acted gingerly in the area of payment cards. The European Economic Commission recommended a Code of

Conduct relating to electronic payments.[22] The Code is addressed to relations between financial institutions, traders and service establishments, and consumers. Its main concern was to foster the objective of interoperability according to which cards issued in member states of the European Community might be used in other member states. Looking forward to compatible cards and interconnected community networks, the recommendation, nevertheless, cautioned that "to produce a rigid, detailed definition of the operation of systems in the midst of change might result in the establishment of rules that would be rapidly overtaken by developments, even constituting obstacles to electronic development...." The recommendation defines "electronic payment" to mean "any payment transaction carried out by means of a card incorporating a magnetic strip or microcircuit used at an electronic payment terminal (EPT) or point-of-sale (POS) terminal." It would then cover debit cards but would exclude "payments by card using mechanical processes (invoice slips)." Traders should be free to install a single multicard terminal or to choose between particular point of sale terminals, as they wish, and contracts between card issuers and traders must contain no exclusive trading clause. Contracts between card issuers or their agents with traders and consumers must be in writing and the result of a prior application. The scale of charges must be determined in a transparent manner. It is expressly stated that electronic payments are irreversible: "An order given by means of a payment card shall be irrevocable and may not be countermanded." Privacy concerns should reflect the practice with checks. Cardholders are enjoined to take reasonable precautions to safeguard the card and must "observe the special conditions (loss or theft) in the contract which they have signed." Finally, the recommendation stipulates that all conditions, provided they conform to law, "shall be freely negotiated and clearly stipulated in the contract."

A more substantive recommendation was issued by the Commission to govern the relationship between the cardholder and the card issuer.[23] Three motivating concerns were that "purchasers of goods and services should be protected against standard contracts, and in particular against the exclusion of essential rights in contracts" (a matter to be discussed subsequently); that they should be protected from damage occasioned by unsatisfactory services; and that the presentation and promotion of goods and services (including financial services) not be designed to mislead them.

An annex details the recommendations and makes it clear that they apply to deposits and withdrawals of cash at automated teller machines, electronic payments involving the use of a card at the point of sale, or such payments effected without the use of a card through home banking, as well as nonelectronic payment by card, including processes for which a

signature is required and a voucher is produced. The recommendation provides that issuers should draw up full and fair terms of contract, specify the basis for their charges, not dispatch a card or other payment device except in response to an application, keep internal records to enable errors to be rectified, and bear the burden of proof that a transaction was accurately entered and was not affected by a technical breakdown. The cardholder's obligations include keeping the payment device and related means to use it safe, not to countermand an order, and to notify the issuer without undue delay of the loss or theft of the payment device and of an unauthorized transaction or error. Following notification to the issuer and provided that the cardholder has not acted with extreme negligence or fraudulently, the latter shall not be liable for loss but shall only be liable for such loss up to the equivalent of 150 ECUs. The card issuer's liability (other than that following notification) shall be limited in the event of nonexecution or defective execution and for unauthorized operations. Card issuers must further provide a means whereby customers may notify loss, theft, or copying of their payment devices.

Recommendations of the Commission do not, of themselves, have binding legal force. The Commission indicated that if banks failed to embody the recommended terms in their contracts, it would consider binding action. Thereafter, three European credit sector associations issued a Code of Best Practice that, however, did not cover the use of credit cards and home banking, and the Commission suggested amendments to it.[24] The Commission then issued a new recommendation[25] that has been expanded to cover stored value cards and electronic tokens stored on network computer memory. The new recommendation is largely based on the prior recommendation of November 17, 1988. It invites member states to take the measures necessary to ensure that the issuers of electronic payment instruments conduct their activities in accordance with the Commission's provisions by no later than December 31, 1998.

Stored Value Card Systems: A Developing Concept

Much interest is currently being focused on stored value cards[26] both in the United States and in the European Community. To obtain such a device, a consumer pays a bank or other card issuer for a card that has been loaded with value. The consumer can then insert the card into a merchant's POS terminal (entering a personal identification number if the system requires this), thereby deducting funds from the card in return for the purchase of merchandise. The merchant is able to transfer the value of accumulated card transactions to his bank account. Some cards depend on magnetic strips, while those that carry more complex information ("smart cards") incorporate microchips. Some cards may be

reloadable, in which case they can be augmented with additional value, while other cards may lack this feature and are considered disposable once their value has been depleted. A further distinction may be made between closed systems in which a card can only be used by its holder to purchase goods and services of its issuer and open systems in which a number of otherwise unrelated merchants may participate thus allowing the cardholder to choose among them.

The issue of what regulation, if any, is appropriate for this newly developing instrument has engendered a number of opinions. In May 1996, the Federal Reserve Board proposed that stored value cards should be subject to regulation under the Electronic Fund Transfer Act through appropriate proposed amendments to be made to its implementing Regulation E. These proposed amendments were to accord with a scheme of classification in which stored value cards were considered to be issued under (i) off-line unaccountable systems, (ii) off-line accountable systems, or (iii) on-line (accountable) systems.

1. In an *off-line unaccountable system,* the record of value that has been imparted to a stored value card is maintained only on the card itself and not in a central database. An example of such a card would be some public transportation farecards. Under the Federal Reserve proposals, such cards would be entirely exempt from Regulation E.

2. In an *off-line accountable system,* while the balance of funds available are recorded on the stored value card, this balance is also maintained at a central data facility, although the authorization of such a facility is not needed to access the funds. It was the view of the Federal Reserve that in such a system there would be an "account" that could bring into play the provisions of the Electronic Fund Transfer Act. Nevertheless, the Federal Reserve did not believe that all of its provisions should be made applicable. In particular, the card issuer should not be obligated to provide to the cardholder transaction receipts or periodic statements. Because the amounts that might be expected to be stored on such cards were likely to be small, the Federal Reserve proposed that they could be exempted from Regulation E's limitation of liability for access cards. The result would be that if a cardholder lost his card, he would lose the balance of the value stored on the card. In addition, the Federal Reserve would not impose the rule against providing cards to those who had not requested them (unless such cards allowed access to the consumer's bank account). The Federal Reserve would, however, impose Regulation E's requirements of disclosure of terms and conditions, fees and charges, the cardholder's liability in the event of unauthorized use, and applicable error-resolution procedures. However, off-line accountable cards that could hold value not in excess of $100 would be completely exempt from the requirements.

3. In an *on-line (accountable) system,* a transaction must be authorized by a central data facility before the stored value card can be used at an ATM or POS terminal. This is because the balance of funds available to the cardholder is not recorded on the card, but only at the facility. The Federal Reserve Board viewed such a card as the functional equivalent of a debit card, although it differed therefrom in two respects. A debit card can access the entire amount of a consumer's account, while the stored value card would be limited in the amount of value that could be accessed. Furthermore, funds accessible by a debit card can ordinarily be accessed through other means, such as checks and deposit withdrawals, while the funds available through a stored value card would not be accessible to the cardholder other than through the use of his card. Once again, the proposals would exempt from all of Regulation E's requirements those systems in which the value of the card could not exceed $100.

Controversy ensued after these proposals were made public. Some observers challenged the proposed analytical classifications, and others suggested that the concept and technology associated with stored value card systems were still in the process of development, and accordingly, it was in the public interest that the evolving products should not be fettered by constraining regulation. In response, Congress stipulated that the Federal Reserve should study the matter further without finalizing its proposed amendments to Regulation E. The Federal Reserve issued a study in March 1997,[27] and further debate and consideration may be anticipated.[28]

In the meantime, the Federal Deposit Insurance Corporation issued an opinion of its general counsel on the question of whether the funds or obligations that underlie stored value cards are deposits so as to qualify for deposit insurance under the Federal Deposit Insurance Act. The opinion considers several alternative systems and concludes that if the funds represented by the value stored on a card remain in a customer's account until the value is transferred to a merchant or another third party who collects them from the customer's bank, then the customer's funds would qualify for deposit insurance. If, however, the funds are paid into a reserve or general liability account at an institution to pay merchants and other payees, then (unless the system is closed) the funds will not qualify for deposit insurance. In a third system in which the electronic value of the cards is created by a third party that holds the funds, with banks acting only as intermediaries in collecting funds from customers, the answer would depend on whether such funds were held by the banks for a period prior to their transfer to the third party. If they were, these funds would qualify for deposit insurance, but not if the bank exchanged its own funds for electronic value from the third party and then exchanged electronic value for funds with its customers.[29] The Office of the

Comptroller has also issued a bulletin advising disclosure of information by banks concerning stored value cards that they distribute.[30] The bulletin also discusses the various risks that banks assume in stored value card systems.

While stored value card systems are still evolving and few persons have as yet called for new legislation to govern them, some observers have begun to consider the legal issues posed by the systems. One task force[31] that considered these issues has set out some interesting problems with suggested conclusions:

- When is the obligation on a stored value card created? The obligation is created when money is exchanged for a stored obligation, not when the card is manufactured. The card is only a storage vehicle.
- Who is the obligor? The issuer is the obligor and should be clearly identified to the purchaser of a stored value card. An agent of the issuer who acts for an undisclosed or partially disclosed principal may also be held liable by the courts.
- May the issuer amend the agreement with the cardholder unilaterally? The answer may be in the affirmative but, if so, the amendment should be given only prospective effect.
- Should the stored value card be transferable by the cardholder to a third party? This would seem to be permissible insofar as property interests are ordinarily assignable under commercial law. If the rule is to be otherwise and the card is not to be transferable, this limitation should be clearly noted on the card.
- Which errors in a system should fall on the issuer of a stored value card and which should be the responsibility of the merchant? This would depend on the nature of the error, having in mind that it is the issuer that has established the controls and technology of the system.
- What should be the rules that govern finality and discharge? Perhaps the courts would fashion a rule so that, in the event of the failure of an issuer, the merchant who accepted the transfer of value from his customer's stored value card prior to that failure would have a claim only on the insolvent estate of the issuer and not on the customer. In this way, the transfer of stored value would constitute final rather than provisional payment.
- Should it be possible to pledge the stored value? A pledge may be possible if the creditor takes physical possession of the stored value card or if provision is made for registering the pledge with the issuer in a system that allows the issuer to block the use of the card during the period of the pledge.

- In the event of equipment failure, who should be responsible for damages? This should depend on who is responsible for the failure.
- If the issuer is liable for a failed transaction, what should be the measure of damages? Damages should be limited to principal and interest. Unless contractually stipulated, there should be no liability of the issuer for consequential or punitive damages.
- Who should bear the risk for a lost or stolen stored value card? If the cardholder cannot reasonably identify the card (as is the case in some off-line systems), he should bear the loss as he would if he had lost cash. If, however, he is able to reasonably identify the lost or stolen card and to prove to the issuer the total outstanding value of the obligation, and the issuer is able to deactivate the operation of the card, then contracts or system rules might shift the risk of the loss.

Wholesale EFT Systems and Applicable Rules

The topics considered above have focused on retail transfers by consumers. Wholesale transfers between banks, for their own account and for the accounts of their corporate customers, however, account for a very sizable proportion of the value of funds that are handled.

FedWire

FedWire is an acronym for the Federal Reserve Wire Network, which is owned and operated by the 12 Federal Reserve banks in the United States. In the early days of the Federal Reserve, financial and administrative messages were sent between the system's offices by telegraph. The network was converted to teletype in 1937 and then fully automated by 1973. Each Federal Reserve bank maintains a district computer system serving the banks within its area. The Reserve banks are, in turn, interconnected through a central facility located in Culpeper, Virginia.

FedWire is used for large interbank payments, such as the transfer of reserve balances maintained by banks on the accounts of the Reserve banks. It is used for the transfer of bank balances and corporate balances and to transfer Treasury and federal agency securities maintained on the books of the Federal Reserve in book entry form. FedWire not only communicates messages regarding these transfers, it functions as a settlement facility. The transfers are credit transfers. If the transferor bank and the transferee bank maintain balances at the same Reserve bank, the transfer is effected by a debit and credit, respectively, on the books of that Reserve bank. If they maintain balances at different Reserve banks, by virtue of their location, the Reserve bank of the transferor bank credits the account of the Reserve bank of the transferee bank, while the latter Reserve bank

debits the account on its books of the sending Reserve bank and credits the account of the transferee bank.

The rules governing transfers of funds through FedWire are set out in Subpart B of the Federal Reserve's Regulation J.[32] Regulation J incorporates Article 4A of the Uniform Commercial Code[33] (except where the latter is inconsistent with Regulation J).

CHIPS

CHIPS is an acronym for the Clearing House Interbank Payment System operated by the New York Clearing House Association. It is an automated communications network and settlement clearing facility that processes, for the most part, international funds transfers between members, although it does handle some domestic transfers as well. There are 122 participating institutions, of which half are U.S. banks. The remainder are U.S. branches and agencies of foreign banks and Edge Act corporations established by U.S. banks. There are two kinds of participating institutions: (i) ordinary participants and (ii) settling participants who must settle not only for themselves but also for ordinary participants who maintain with them correspondent balances. Although the CHIPS rules provide that once sent, or released from storage, a payment message constitutes an unconditional obligation of a participant to make payment and is ordinarily irrevocable, CHIPS transactions are not immediately final in the manner of those of FedWire. They become final only at the end of the day, thus resulting in "same day availability" instead of FedWire's "immediate availability."

At the end of a CHIPS day, all payment messages are netted and each individual participant's overall position vis-à-vis all other participants is calculated, giving rise to what is called its "net net balance," which it is obligated to settle. A further calculation is made to determine the aggregate position of each of the settling participants who then settle, for themselves as well as for the ordinary participants with whom they are in correspondent relation. If a settling participant's position is in debit, it must transfer funds to a settlement account maintained at the Federal Reserve Bank of New York. CHIPS has a set of rules governing its system and has selected New York's version of Article 4A of the Uniform Commercial Code as its legal framework.

Society for Worldwide Interbank Financial Telecommunication (SWIFT)

The Society for Worldwide Interbank Financial Telecommunication was organized under Belgian law as a nonprofit cooperative company. It

is an international communications system for messages among its member institutions in most of the countries in the Americas, Europe, Japan, and certain countries in Asia. Its member institutions are banking organizations that engage in transmitting international financial messages, and certain nonbanking institutions. Unlike FedWire and CHIPS, which are facilities for communication and settlement, SWIFT is purely a message facility. It links individual members, national communications centers, and regional processors through dedicated networks devoted exclusively to the transmission of SWIFT messages. Settlement between members may be effected through offsetting debits and credits to correspondent accounts maintained with one another or with intermediary banks. A SWIFT message may also be settled through FedWire, CHIPS, or the payments transfer system of another country.

SWIFT messages are encrypted, and there is a different tariff according to the urgency indicated for the message. Because settlement occurs through arrangements external to the system, messages bear a value date when the amount of the transfer is to be at the disposal of the transferee bank and a pay date on which the transferee bank or a correspondent thereof is requested to credit or pay funds to the beneficiary of the message.

UNCITRAL Model Law on International Credit Transfers Compared with Uniform Commercial Code Article 4A

With the notable exception of the United States, most countries do not have legislation dealing with electronic funds transfers as such. As has previously been noted, the United States has adopted the Electronic Fund Transfer Act that governs consumer transfers. Moreover, all states in the United States have adopted Article 4A, an amendment to the Uniform Commercial Code, in order to deal with wholesale large-value fund transfers. With the volume and value of international electronic funds transfers increasing each year and only the incomplete rules of particular systems to govern the rights and liabilities of parties to the transfers, the United Nations Commission on International Trade Law set about creating a model law to govern international transfers.

It was the hope of some that, in the interest of uniformity, the model law would resemble UCC Article 4A.[34] As the drafts of the model law progressed, the later drafts did evidence a tendency to draw closer to the provisions of UCC Article 4A. However, despite this tendency, a number of differences remain. In order to understand the issues, it may be appropriate to compare certain key points of UCC Article 4A and the UNCITRAL Model Law.

In a typical example of an electronic funds transfer, an originator who wishes to transfer funds to a beneficiary will order the originator's bank

to send to the beneficiary's bank a transfer of funds through one or more intermediary banks. In the terminology of UCC Article 4A, the complete transfer is called a "funds transfer," and each segment of that transfer occurs by way of a "payment order." In the terminology of the UNCITRAL Model Law, the complete transfer of funds is called a "credit transfer," and each segment thereof is effected by a "payment order." Both laws deal with consumer transactions and neither deals with debit transfers. The UNCITRAL Model Law deals with consumer transfers (although it does not deal with issues related to consumer protection). While UCC Article 4A could apply to a transfer effected for a consumer, it does not apply to a transaction if any part thereof is covered by the Electronic Fund Transfer Act.

The basic approach of UCC Article 4A is to place the burden of responsibility on the originator or any sender, while the UNCITRAL Model Law seeks to fasten a measure of responsibility on the receiving bank, as well, for the completion of the transfer. Thus, the UNCITRAL Model Law requires a receiving bank that detects certain errors or inconsistencies in payment orders that are received to give its sender notice of errors or inconsistencies (Articles 8(4), 8(5), 10(2), 10(3), and 10(4)). Such errors might, for example, indicate that the payment order has been misdirected or that it contains inconsistencies in its terms and instructions. By contrast, UCC Article 4A does not require the receiving bank to give its sender notice of such errors. The significance of this difference is that receiving banks may, pursuant to the agreed procedure between the parties, be subjected by the UNCITRAL Model Law to a duty to examine incoming payments orders. The duty may be determined under a subjective test (Articles 8(5), 10(3), and 10(4)) or an objective test (Articles 8(4) and 10(2)). The proponents of UCC Article 4A maintain that such a duty would impede and make more costly a high-speed automated system of fund transfers that is required in the modern commercial world.

Another difference between the two laws is their approach to the issue of whether or not consequential damages may arise if a bank is at fault for an incomplete transfer. Both laws attempt to circumscribe the liability that may attach to a bank by way of consequential damages. UCC Article 4A envisages the possibility of consequential damages arising under certain circumstances—that is to say, if the beneficiary's bank has received notice of special facts and, nevertheless, refuses after the beneficiary's demand to make payment (Section 4A-404(a)).[35]

Both UCC Article 4A and the UNCITRAL Model Law make the originator's bank and subsequent intermediary banks responsible for the arrival of a fund transfer at the beneficiary's bank. They do this through what, in effect, amounts to a "money-back guarantee." According to this

guarantee, a receiving bank is required to refund with interest an amount that has not properly arrived at the beneficiary's bank. Thus, if the beneficiary's bank does not accept a payment order for the benefit of the beneficiary, the originator need not make payment and, if he has done so, is entitled to get the money back. The manner in which Section 4A-402(d) deals with this money-back guarantee is similar to that of Article 14, but the latter allows the originator's bank to vary the obligation by agreement under circumstances involving a significant risk.

Both UCC Article 4A (Section 4A-209 and 210) and the UNCITRAL Model Law (Articles 7 and 9) contemplate that a receiving bank may either accept or reject an incoming payment order. Both laws (Section 4A-210(a)) (Articles 7(3) and 9(2)) require a receiving bank, in the event that it chooses to reject the payment order, to give notice of such rejection to the sender. (Under Section 4A-210(b) of UCC Article 4A, and Article 7(3)(a) and Article 9(2)(a) of the UNCITRAL Model Law, this duty is subject to the assumption that there are sufficient funds of the sender on deposit with the receiving bank or, in the case of the UNCITRAL Model Law, that payment is made by other means.) The consequence of not giving notice varies under the two laws. Under UCC Article 4A, the liability brings into play an interest penalty. Under the UNCITRAL Model Law, the failure to give notice of rejection may lead to acceptance of the payment order under Article 7(2)(e), in the case of a receiving bank that is not the beneficiary's bank, and under Article 9(l)(h), in the case of the beneficiary's bank.

Under UCC Article 4A, the nature of acceptance depends on whether the acceptor is a beneficiary's bank or another bank. In the case of the originator's bank or an intermediary bank, acceptance occurs when that bank issues its own payment order so as to implement the originator's payment order (Section 4A-209(a)). At this point, the sender is obligated to pay the amount of the payment order to the receiving bank (Section 4A-402(b) and 4A-209 Official Comments 1 and 4). In the case of the beneficiary's bank, acceptance occurs when it pays the beneficiary, notifies the beneficiary of receipt of the payment order, receives payment by the sender, or in certain cases, fails to reject the payment order (Section 4A-209(b)(1),(2) and (3)). By way of comparison, under the UNCITRAL Model Law the originator's bank or an intermediary bank accepts the sender's payment order, among other ways, when the bank issues an implementing payment order, when it debits an account of the sender, or when the time for rejection has elapsed without notice having been given (Article 7(c)-(e)). In the case of a beneficiary's bank, acceptance occurs, among other ways, when the bank gives notice to the sender of acceptance, when it debits an account of the sender, when it credits the beneficiary's account, when it gives notice to the beneficiary of the right to

the funds, or when the time for giving notice of rejection has elapsed (Article 9(1)). A sender's obligation to pay the receiving bank arises when the receiving bank accepts the payment order (Article 5(6)). In most cases, execution of the payment order by the receiving bank is simultaneous with its acceptance of the payment order, and payment is due from the sender upon such execution. If the sender maintains an account with the receiving bank, payment may be made by debiting that account (Article 6(a)). Alternatively, if the sending bank maintains an account in favor of the receiving bank, payment may be made by crediting that account and becomes effective when used by the receiving bank (Article 6(b)(i)). Other means of payment involving accounts in third-party banks or at a central bank and pursuant to the rules of a fund transfer system are also authorized (Article 6(b)(ii)-(iv) and (c)). Similar means of payment are set out in UCC Article 4A (Section 4A-403).

Both laws provide for what is called a "security procedure" in UCC Article 4A (Section 4A-201) and an "authentication procedure" in the UNCITRAL Model Law (Article 2(i)). The implications of such a procedure are that a sender may be bound by a payment order purportedly sent by him or by his agent if the payment order complies with a commercially reasonable method of security against unauthorized payment orders even if, in fact, it has been sent by a wrongdoer without authority.

UCC Article 4A requires, by way of Section 4A-302(a)(1), that the instructions of an originator be strictly followed concerning any intermediary bank or funds-transfer system to be used in effecting the funds transfer. However, the UNCITRAL Model Law (Article 8(3)) permits an intermediary bank to inquire of the sender for additional instructions if it determines that it is not feasible to follow the original instructions or that they would cause excessive costs or delay. Both UCC Article 4A and the UNCITRAL Model Law provide for the cancellation and amendment (Section 4A-211) or revocation (Article 12) of payment orders, provided that these are received within a reasonable time before a receiving bank has executed a payment order or, in the case of the beneficiary's bank, before the transfer is completed and the funds are placed at the disposal of the beneficiary.

Finally, it should be noted that the scope of the UNCITRAL Model Law is limited to transfers where the sending bank and the receiving bank are in different countries (Article 1),[36] while Article 4A may govern national and international transfers. As has been noted, both laws are intended to govern credit transfers (rather than debit transfers) and, while Article 4A excludes consumer transactions if they are in any part governed by the Electronic Fund Transfer Act (Section 4A–108), the UNCITRAL Model Law includes consumer transfers (although it does not deal

with issues related to the protection of consumers) (Article 1, footnote). Both UCC Article 4A and the UNCITRAL Model Law contain conflicts rules in order to determine which law will govern a given transaction. The provisions of these conflicts rules, however, differ. Moreover, the conflicts provision of the UNCITRAL Model Law is independent of the other provisions and, accordingly, may or may not be adopted by a state that adopts the UNCITRAL Model Law. (Compare Article Y of the UNCITRAL Model Law with UCC Section 4A-507.) Both Article 4A and the UNCITRAL Model Law (Article Y (1)) provide that, unless otherwise agreed, the law of the receiving bank will govern the relations between the sender and that bank (Section 4A-507(a)(1)) (while Section 4A-507(a)(2) also provides that, in a dispute between the beneficiary and the beneficiary's bank, the law of that bank will govern). While Article 4A expressly recognizes that system-transfer rules may select the law of a particular jurisdiction (Section 4A-507(c)), the UNCITRAL Model Law is silent on the matter.

UNCITRAL Model Law on International Credit Transfers Compared with the EC Council Directive on Cross-Border Credit Transfers

Following the issuance of a Commission recommendation[37] and a proposed directive,[38] a Council Directive on cross-border credit transfers was issued in 1997.[39] It is a somewhat abbreviated set of rules that deals with particular issues. It is limited to credit transfers of amounts less than ECU 50,000 in line with its objective of allowing individuals and small and medium-sized businesses to be able to make credit transfers rapidly, cheaply, and reliably within the European Community in the currencies of the member states.[40] It requires credit institutions to provide clear information about their credit transfer services concerning the time needed to effect payment, the manner of calculation of fees and charges, the value date, the reference exchange rates, and the complaint and redress procedures available to customers,[41] as well as relevant information subsequent to the execution or receipt of a transfer.[42]

In orientating itself toward consumer protection, it differs from the UNCITRAL Model Law in which an optional footnote to Article 1 states that the UNCITRAL Model Law does not deal with consumer protection issues. In this regard, the UNCITRAL Model Law has no comparable provisions requiring the information stipulated by Articles 3 and 4 of the Directive. In the absence of an agreement between the originator and his financial institution, the funds called for must be credited to the account of the beneficiary's institution by the end of the fifth banking business day following the date of acceptance of the credit transfer order

by the originator's financial institution.[43] The beneficiary's institution then must make the funds available to the beneficiary by the end of the business day following the day on which the funds were credited to the account of that institution.[44] While the obligation of the originating bank under Article 6 of the Directive thus corresponds to the obligation of such a bank under Article 11 of the UNCITRAL Model Law, Article 10 of the latter, which deals briefly with the obligations of the beneficiary's bank, refers only to the governing law for guidance.

The UNCITRAL Model Law, it should be noted, obligates any sending bank to execute a payment order within two days, while the obligations of an intermediary bank to act in a timely manner are only inferred in the Directive from its obligation to compensate the originator's institution if the delay in making payment within the applicable five days (or otherwise agreed period) is attributable to it.[45] An important difference between the UNCITRAL Model Law and the Directive is that the former allows one or more of the receiving banks in a credit transfer to deduct charges notwithstanding that this may result in the amount of the payment order that is ultimately accepted by the beneficiary's bank being less than the amount of the originator's payment order.[46]

By contrast, the Directive requires that the originator's institution, any intermediary institution, and the beneficiary's institution execute the credit transfer for the full amount (unless the originator has specified that the costs of the credit transfer are to be borne by the beneficiary who demands the full amount specified in a contract). (The Directive reflects in this regard section 4A-302(d) of the Uniform Commercial Code.) In the UNCITRAL Model Law, there is an obligation to refund ("money-back guarantee") that arises from several scenarios: (i) a credit transfer is not completed,[47] (ii) the amount transferred exceeds the amount of the order received,[48] or (iii) an order is executed in disregard of an effective revocation order.[49] In the Directive, the obligation to refund is limited to amounts not exceeding ECU 12,500 in the event that the account of the beneficiary's institution is not credited.[50] This amount is supplemented by interest and charges.[51] Each intermediary institution that has accepted the credit transfer is liable to the institution that instructed it to carry out the order, and the originating institution must recredit the account of the originator. (Interest is also payable on the remaining amount of funds that have not been credited within the applicable time period—to the originator by the originator's institution[52] or to the beneficiary by the beneficiary's institution.)[53] It should be noted that while the UNCITRAL Model Law permits revocation of a payment order if it is received by the receiving bank in time to allow it a reasonable opportunity to act,[54] no provision for revocation is provided in the Directive. By way of comparison, UCC Article 4A provides that a sender may cancel or amend

a payment order if notice thereof is received by the receiving bank before it accepts the payment order and in time to allow it a reasonable opportunity to act upon it.

Netting

Banks have long used systems of netting transactions between them. Derived from check collection, the practice has been introduced to payment orders in electronic funds transfers and to various types of contractual commitments as well. An example may serve to illustrate this development. Suppose that during the course of a day, two banks issued payments orders to each other in response to their customers' requests. If Bank A issued 12 orders to Bank B and the latter issued 6 orders to Bank A, there would be a total of 18 payment orders issued. Instead of making payments at the time of each transaction, it is possible to net this number if the two banks agree. The banks might agree to wait for the end of the business day, at which time the amounts of the payment orders would be set off against each other and a single payment made from the net debtor bank to the net creditor bank. Risks of error and fraud could be reduced, and the costs of payment and settlement reduced.

In the example posed, but two banks were involved. However, it is possible to extend the concept to a multilateral system of banks as well. To understand this concept, it is helpful to consider and differentiate between three basic systems: (i) gross settlement without intraday credit, (ii) gross settlement with intraday credit, and (iii) net settlement.

In a *gross settlement system*, payment orders are expected to be honored on a transaction-by-transaction basis. Funds are held on deposit so that the order can be effected by the operator of the system (ordinarily the central bank or other manager of the system). If funds are not so available, the operator will return the order to the originating bank or will hold it in queue until sufficient funds accumulate in the account of the originating bank to allow its payment order to be executed. The norm in the system is characterized as a real-time gross settlement. An example of such a system, where there is no facility for the extension of credit, is the Swiss Interbank Clearing System.

An alternative *gross settlement system* can be constructed in which the operator may extend credit on an intraday basis in the event that the account of the originating bank lacks sufficient funds to effect its payment order. In this kind of system, the operator (ordinarily a central bank) will have assigned limits to the amount of credit that it is willing to extend to each of the participating banks, perhaps based on the capital of each. The operator will expect the required funds to be put into the accounts of

banks to which credit has been extended before the close of the day. An example of this system is FedWire.

In the third system (the *net settlement system*), settlement is not intended to be carried out on a transaction-by-transaction basis. Instead, it will be effected at designated times during the course of a day. In such a system, it is anticipated that the payment orders of the participating banks will be netted at such times. In these systems, credit is extended by the participating banks to each other rather than by the operator. The operator of a net system may be the central bank, as in BOJNET, or an association of banks, like the New York Clearing House that operates CHIPS. Since the participating banks are responsible for the extension of credit, each may be required to calculate the credit limit that it will extend to each of the other participants. The proponents of such net settlement systems point out that they reduce the amounts that participating banks would otherwise have to take from the operation of their business in order to fund their accounts with the operator of a gross settlement system. In addition, net settlement systems are less likely to give rise to gridlock situations, in which banks must wait for other banks to perform on a transaction-to-transaction basis before they, themselves, will be funded sufficiently to enable the operator to proceed to implement their own payment orders.

A consideration of the various aspects of netting systems has given rise to a set of minimum standards for the design and operation of cross-border and multicurrency netting and settlement systems. These standards are called the Lamfalussy standards after the Chairman of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries that proposed them. The first of these standards is that such netting systems should have a well-founded legal basis under all relevant jurisdictions. A significant legal issue that may arise is that in some jurisdictions the insolvency of one of the participating banks may result in a situation in which the netting envisioned by the system may be negated by the legal rules of the jurisdiction of the insolvent bank participant. This could occur through a process known as "cherry-picking" if, pursuant to such rules, the receiver of the insolvent bank could confirm the performance of transactions already executed by a counterparty while simultaneously disaffirming the insolvent's obligations in favor of that counterparty. In order to clarify such situations in favor of the netting principles that are at the heart of their systems, some countries have sought legislative amendment of relevant statutes. Thus, in the United States, the Bankruptcy Code and the Federal Deposit Insurance Corporation Act have been amended, and further changes have been made by the Federal Deposit Insurance Corporation Improvement Act of 1991.[55]

Regulation and Contracts

Rights and obligations of the parties to various payment systems can be regulated by law, by contract, or by some combination of the two. As will be appreciated from the foregoing analysis, the older forms of payment, such as cash and checks, are largely governed by law, although at least in the case of checks, some of the statutory provisions may be varied by contract.[56] Moreover, in the case of newer forms of payment, where a statute is applicable, the power of the parties to vary some of its provisions may be expressly recognized.[57]

Payment card systems are governed by contract in most countries, although banks and other card issuers may issue nonbinding codes of practice (frequently under government stimulus). In the United States (and in Denmark),[58] statutes have been passed and regulations issued to establish a legal framework for payment cards, and the contracts between the issuer, its agents, merchants, and consumers have reflected that framework and amplified its provisions. In the United States, as discussed above, there is also a statute that governs wholesale electronic funds transfers. In the European Community, increasing recognition is being given to the need to establish a legal framework for the purpose of providing uniform payment systems that may be used to make payments throughout the European Community. Accordingly, recommendations and directives are being issued to provide such frameworks, and a consensus is emerging that, if banks and other sponsoring parties of these systems fail to come up with adequate codes of practice and contracts that embody their terms, then what had been the subject of recommendations may need to be addressed by directives. This approach has been adopted both for payment cards as well as for electronic funds transfers (below a threshold amount, as explained above).

With the exception of the United States, wholesale electronic payment systems are governed by a hodgepodge of rules (public and private) and contracts that do not provide for a comprehensive and transparent legal regime. It is instructive in this connection to read the prefatory note of the National Conference of Commissioners on Uniform State Laws and the American Law Institute, which accompanied the official version of Article 4A of the Uniform Commercial Code. After asking why Article 4A is needed, the note states:

> There is no comprehensive body of law that defines the rights and obligations that arise from wire transfers. Some aspects of wire transfers are governed by rules of the principal transfer systems. Transfers made by FedWire are governed by Federal Reserve Regulation J and transfers over CHIPS are governed by the CHIPS rules. Transfers made by means of automated clearing houses are governed by uniform rules adopted by various associations of

banks in various parts of the nation or by Federal Reserve rules or operating circulars. But the various funds transfer system rules apply to only limited aspects of wire transfer transactions. The resolution of the many issues that are not covered by funds transfer system rules depends on contracts of the parties, to the extent that they exist, or principles of law applicable to other payment mechanisms that might be applied by analogy. The result is a great deal of uncertainty. There is no consensus about the juridical nature of a wire transfer and consequently of the rights and obligations that are created. Article 4A is intended to provide the comprehensive body of law that we do not have today.

The conclusion that a statutory framework is necessary for a payment system has not, however, been accepted by all observers. Many have argued that, especially in the case of new and evolving systems, imposing a legal framework at too early a stage may result in constraining the development of a preferred technology and a system based on it. Others, however, have pointed to anomalous results when a system is left solely to be governed by contract.

An analysis of such anomalous results has indicated several important areas where government standards may be needed in payment card systems. These areas are as follows:[59]

- Banks and other card issuers may engage in the unsolicited issuance of electronic payment cards and/or personal identification numbers or PINs. This practice has led in some cases to cards and PINs being sent by a bank to the wrong address and their fraudulent use by a stranger.
- Adequate disclosure of the terms and conditions of the contracts that will bind a cardholder may not be made available to him prior to his entering the arrangement.
- Consumers may not receive a printed record of each electronic banking transaction. This makes it difficult or impossible to reconcile a bank statement with a withdrawal or debit that is in question.
- Changes in the contract terms and conditions may occur without adequate notice to the cardholders.
- The consumer's liability for unauthorized use of his payment card may be left for the card issuers to decide instead of being regulated by statute.
- In some countries, the burden of proof in the event of a dispute may be put on the cardholder instead of the card issuer.
- When the electronic payment system goes wrong (e.g., stopping for a period of time, providing the wrong amount of cash, or debiting

an account incorrectly), should the card issuer that maintains the system be liable in damages?

- Should a procedure be required by which the cardholder who loses his card may notify the issuer at any time?
- Should error resolution procedures be left to card issuers, or should they be specified by statute?

There is a legal rationale for concluding that in the payments area it may be necessary for the government to establish standards that must be reflected in the contracts that govern the relations between the parties. This rationale is based on the consideration that payment contracts are not likely to be ordinary contracts based on the consensus of the parties, but are far more likely to represent the adhesion of one or more of the parties to the stipulations of a single party (the bank). Such contracts are called ***adhesion contracts*** and share five principal characteristics:

1. The contracts are based on standard forms.
2. They are used to supply mass demands for goods and services.
3. They are drafted for the public, that is, for an indefinite number of persons, rather than a single individual.
4. Their use is entangled with the superior bargaining power of the stipulator that is, to a certain extent, a monopolistic body.
5. The individual customer has no bargaining power; he must either adhere to the contract or refuse to contract altogether.[60]

The adhesion contracts may be distinguished from commercial standard form contracts (like building contracts), which may serve as a model between parties of relatively equal bargaining power. Commercial standard form contracts have been widely adopted because they facilitate trade. Moreover, these contracts may be varied in their particulars by the parties. In contrast, adhesion contracts are often associated with monopoly power. The weaker party is merely presented with a form that he is requested to sign, or he will forgo the benefit that would otherwise accrue from entering into the contract. Adhesion contracts are not drafted with individuals in mind, but for the public in general; it is in this light that society has distinguished them from ordinary contracts, which are the product of bargains entered into through a meeting of minds based on the process of offer and acceptance.[61] It is submitted that, in most instances, contracts offered by banks and other sponsors of payment systems are in the nature of adhesion contracts.

The response of many societies to adhesion contracts is to remove them from the area of private contracts and to subject them to guidelines and standards that are believed to reflect the public interest. That the

countries of the European Community and the United States have chosen to set standards through legal frameworks for payments contracts is not mere coincidence. It proceeds naturally from the nature of payments contracts. It is submitted that it is likely that this approach will increasingly be adopted elsewhere in the world.

* * *

The subjects treated in this volume attempt to place the central bank in the context of rapidly changing developments. After surveying developments at the international financial institutions, the volume treats three main areas of interest: payments issues, dealing with banks in distress, and the resolution of sovereign liquidity crises. A final section explores several matters of special interest: the regulation of derivatives activities of banks, bank secrecy, and financial services in the General Agreement on Trade in Services.

This volume is the fifth in a collection of revised proceedings of seminars that have been sponsored by the International Monetary Fund's Legal Department, in conjunction with the IMF Institute, for general counsels of central banks. The volume, which reflects topics originally addressed at the 1996 seminar, contains the collected views of many of the foremost thinkers and actors in the field of banking having particular reference to the legal aspects of the matters discussed. Following the main papers of the proceedings are the remarks of a number of distinguished commentators. Each of these commentators offers a distinct perspective on a given subject. The main areas of interest are set out with forewords by way of introduction and afterwords by way of conclusion. Hypotheticals are introduced by a number of commentators to serve as illustrations of the issues. The views expressed in the various papers and commentaries are those of the authors and should not be interpreted as reflecting the views of the International Monetary Fund or any other institution.

* * *

Mr. Gianviti surveys the history of special drawing rights (SDRs), describes their purposes, reviews the conditions for an allocation of SDRs, and analyzes proposals for such an allocation. He explains that SDRs were created by the First Amendment of the International Monetary Fund's Articles of Agreement for the purpose of supplementing existing reserve assets. He notes that they were not explicitly recognized as reserve assets. Their main use was to be exchanged for currencies among Fund members. At the time of the Second Amendment, however, SDRs were made the unit of account of the Fund's General Resources Account (instead of gold), and it was expressly stated that they were intended to become the

principal reserve asset of the international monetary system. He notes that a country's reserve assets now include four categories of assets: gold, foreign currencies, its reserve position in the Fund, and SDRs. Mr. Gianviti compares and contrasts these four categories of assets. In his analysis of SDRs, he explains that the creation of SDRs was the result of protracted discussions. Various proposals were put forward to create a new source of liquidity, additional to existing reserve assets, which could be created by a deliberate action of the world community and injected into the world economy in order to avoid a general deflation, although subject to some strict conditions to avoid a general inflation. He states that, at first, the creation of the SDR appeared to be a complete success: SDR 9.5 billion were allocated by the Fund in 1970–72. Thereafter, unexpected economic developments cast a doubt on the continued need for SDR allocations. Nevertheless, further allocations of SDR 12 billion took place in the 1979–81 period. From that time until 1997, there had not been an allocation of SDRs. Mr. Gianviti introduces the subject of the debate over whether there was a need for a new SDR allocation. He then provides an example of how the SDR system operates. Moreover, he describes the process of an allocation of SDRs, the applicable accounting rules, and the cancellation of SDRs. Mr. Gianviti explains the two functions of the SDR—as a unit of account and as a reserve asset. Thereafter, he discusses the substantive conditions for an SDR allocation. In conclusion, Mr. Gianviti reviews and analyzes various proposals for such an allocation. The Board of Governors of the IMF has now approved the proposed amendment of the Articles of Agreement to allow for a special one-time allocation.

Mr. Holder examines the role of lawyers in the International Monetary Fund, an organization possessing international legal personality. First, he spells out the objectives, structure, and functions of the IMF, noting that its legal activities reflect these features. He states that the Fund is an intergovernmental, international organization, whose authority and power derive from its constitutional document, the Articles of Agreement. He details IMF functions as set out in the Articles and describes how the Articles expand on their execution. Second, he describes the gamut of tasks that are performed by the Legal Department. Mr. Holder comments that, since 1946 when the Legal Department was first established in the IMF, it has become a necessary part of decision making, and, consequently, the Department has contributed to practically all of the Fund's activities. He goes on to describe how the work of the Department falls generally within four functional categories—general legal issues, country-specific issues, administrative affairs, and technical assistance—and examines each category in detail. Third, he answers the following questions: Who are the clients? What

form does legal advice take? Where is the law found? Finally, Mr. Holder makes some general observations about the lawyer's role in the IMF. He concludes that IMF lawyers are primarily dealing with member states and are caught up in the historic shift of authority from exclusive national authority ("sovereignty") to that of cooperative international authority.

Mr. Shihata considers the role of the World Bank and its affiliate institutions, the World Bank Group, in the 1990s and contends that the World Bank is the most qualified institution to meet the challenges of global development. He addresses the changes that have occurred within the World Bank relating to its membership, operations, internal structure, and related matters. He points out that the growth in the World Bank's membership has paralleled the widening and intensification of international linkages in trade and finance, termed "globalization," and that such developments have greatly influenced the types, scope, and modes of operations of the World Bank. Mr. Shihata examines the greater emphasis being placed on private sector development, social development, governance, the environment, and debt reduction. Regarding governance, he notes that the lending for improvement in this area has supported legal, judicial, and civil service reform, including the introduction of measures to enhance public accountability and greater transparency in government actions. He also describes the World Bank's new lending instruments and business practices, and its internal structure and culture, noting that the main purpose of recent organizational changes was to transform the World Bank into a more result-oriented institution. Mr. Shihata maintains that the World Bank's demonstrated readiness to adapt itself to meet world needs, its ability to continuously improve its strategies and operational practices, and its dynamic new leadership are the factors of promise that should help it meet new challenges.

Ms. Aizawa reviews developments at the International Finance Corporation (IFC), which marked its fortieth anniversary in 1996. She points out that the IFC is now the world's largest multilateral source of direct investment for private project financing in developing countries and describes its roles as an investor in the private sector and a mobilizer of resources (through its "B" loan program). Ms. Aizawa focuses on the IFC's privatization and advisory services, financing of infrastructure projects, and capital markets development. She also describes the IFC's assistance to small and medium-scale enterprises and its focus on the environment. She concludes that the IFC's activities reflect the belief that market forces must play a greater role in the economies of developing countries if sustained growth is to be achieved.

Ms. Tibbals Davy, in a paper she presented, considers the risk associated with the settlement of foreign exchange transactions. She points out

that, given the estimated $1 trillion plus of foreign exchange trades arranged daily, the resulting large exposures raise significant concerns for individual banks and the entire international financial system. These concerns include the possible effects of such risk on the safety and soundness of banks, the adequacy of market liquidity, market efficiency, and overall financial stability. Ms. Tibbals Davy describes how the collapse of Bankhaus Herstatt in 1974 brought foreign exchange settlement risk into sharp focus and then turns her attention to *Settlement Risk in Foreign Exchange Transactions*. This report, which was issued by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries, analyzes the existing arrangements for settling foreign exchange trades and offers practical approaches for reducing foreign exchange settlement risk. Ms. Tibbals Davy goes on to identify legal issues raised by the Committee's specific findings and recommendations, including finality and choice of law, netting, and cross-border issues (especially regarding insolvency legislation). She concludes that (i) individual banks can control their foreign exchange settlement exposures by applying appropriate credit control processes to their foreign exchange settlement exposures, (ii) industry groups can develop well-constructed multicurrency services that contribute to the risk-reduction efforts of individual banks, and (iii) central banks in cooperation with the relevant supervisory authorities can foster private sector action.

Professor Bhala examines cross-border electronic banking and focuses on the systemic risk and sovereignty issues that it raises. He begins by defining the concept of cross-border electronic banking. Thereafter, he elaborates on two challenges. First, he considers whether cross-border electronic banking has rendered the international banking system inherently more volatile. His affirmative answer is based on an examination of six components of systemic risk: credit, market, market liquidity, payment or settlement, operational, and legal risks. Second, he suggests that the electronic technology employed in cross-border electronic banking has eroded the autonomy of central banks to conduct their own banking policies. Professor Bhala examines the conflicts that arise from the process of determining what law applies to a cross-border electronic banking transaction. He notes that never before has the difficulty of central banks to keep pace with change been so obvious. This difficulty raises a significant issue concerning the appropriate role of a central bank that finds itself perpetually behind the curve of developments. For example, should it promote market-based self-regulation? Professor Bhala contends that cross-border electronic banking highlights the need for central banks to redouble their efforts to reach agreement on supervising such transactions.

Mr. Baxter addresses the legal uncertainty surrounding stored value products and the dilemma it has produced. On the one hand, legal uncer-

tainty may undermine public confidence in a nascent payments system and stifle its development, but on the other hand, premature adoption of rigid legal rules can hamper competitive product development. Mr. Baxter defines a happy balance in this situation as sufficiently clear legal rules to assess liability and risk, without being so costly and constraining that they become an iron cage. He provides an overview of stored value products—what they are and how they work—and discusses their credit feature. Then, through an example, Mr. Baxter considers the evolution of a stored value product from creation, through its transfer, to final settlement and discharge. He points out that, by focusing on each of these stages, it becomes clearer when commercial law issues can be resolved by a written contract between the parties to the transaction or when a special legal rule is necessary. He emphasizes the importance of adopting a finality rule. Finally, Mr. Baxter examines some issues of particular relevance to central bankers, such as choice of law, lost or stolen obligations, and foreign exchange risk. He concludes that central banks can help foster the development of appropriate rules, thereby permitting stored value products to act as an efficient payment mechanism for consumers without unnecessary or uncontrollable risk.

Professor Guest compares the common law and the Geneva systems in their treatment of the legal incidents of checks and their collection. First, he compares the definitions of checks found in the United Kingdom's Bills of Exchange Act and the United States' Uniform Commercial Code with that found in the Geneva System's Uniform Law on Cheques. Second, he examines a host of issues related to these definitions, including the definitions of bank, postdated check, assignment of funds, and transferability. Other issues examined are certification, presentment, countermand of payment, and the effects of a drawer's death or of a "crossing" of the check. Professor Guest describes annotations sometimes found on checks, such as "not negotiable" and "account payee," and checks defined as payable through a bank and payable in account. He surveys the liability of parties to forged or stolen checks. Finally, he considers the collection of checks, focusing on the liability and protection of the collecting bank, the effect of delays, and truncation of the check collection process.

Mr. Feldberg surveys approaches to bank supervision. He notes that technological advances, product innovation, globalization, structural changes, and deregulation—together with a wave of broad-scale banking problems in a number of countries—have fundamentally altered the business of banking. These trends, he contends, have produced major new challenges for bank supervisors and have raised questions in many countries about the adequacy of bank supervisory techniques and overall performance, as well as about the need for fundamental changes in

supervisory approaches. Mr. Feldberg first describes the different types of supervisory models in use among the Group of Seven countries, concentrating on the role of on-site examinations and the supervisors' relationships with external auditors. He identifies common themes, one of which is a noticeable shifting of emphasis in supervisory practices from detailed transactional reviews to a more risk-based and process-based focus. Second, he details the U.S. supervisory approach and discusses its emphasis on developing and administering prudential policies. In addition to describing the supervisory tools used in normal circumstances, Mr. Feldberg examines the U.S. approach in times of stress. Finally, he surveys the work of the Basle Committee on Banking Supervision, including its efforts in the area of prudential risk-based capital requirements; its work on risk management and derivatives; its efforts to establish the principle of comprehensive consolidated supervision; and its efforts to achieve close collaboration among bank supervisors and other financial regulators.

Mr. Ireland describes the central bank's role in bank closures and focuses on its role as lender of last resort. He notes that the classic lender of last resort provides liquidity to solvent banks when they are unable to meet their liquidity needs from other sources. A critical element is whether the bank needing liquidity assistance is a viable entity. Mr. Ireland reviews U.S. legislation designed to reduce the costs to the deposit insurer of resolving troubled banks, and against this background, he considers two examples of bank "failures." The first is Continental Illinois National Bank, which was rescued on a basis that was probably not "least cost" out of concerns for systemic consequences, and the second is the Ohio thrift crisis, a series of failures that might be characterized as systemic, at least in a particular geographical area. Regarding Continental, he examines why it was "rescued" rather than liquidated. As to the thrift crisis, he notes that it highlights the limitations inherent in the classic lender-of-last-resort function when good supervisory information is not available. Mr. Ireland suggests that the central bank's powers as lender of last resort can serve as a vital source of funds to borrowing institutions but, if used inappropriately, these same powers can result in preferring creditors and encouraging their early flight from troubled banking institutions.

Mr. Josefsson examines bank failures that occurred in the Nordic countries, focusing on the severe banking crises in Finland, Norway, and Sweden. In these countries, authorities took drastic actions to support problem banks, and, in order to safeguard the banking system's stability and to protect depositors' money, spent large amounts of taxpayer money to rescue insolvent banks. Mr. Josefsson examines these crises to elicit lessons regarding the complex process of bank rescue operations. First, he identifies the causes of the crises: bad banking, the international reces-

sion, and bad economic policies. Second, he considers the role of deposit insurance and government support in each of these countries. Additionally, Mr. Josefsson describes special organizations that were set up to manage the support system for the bank restructuring and to decide on the measures to be taken. He also reviews the types of support provided and the public cost of bank restructuring. Mr. Josefsson concludes, among other things, that (i) government authorities need to take action immediately once there are indications of an imminent bank crisis, (ii) a deposit protection scheme cannot solve a systemic bank crisis, (iii) the government should be responsible for restructuring through a special government agency, (iv) bad assets should be transferred to an asset management company outside of the banks, and (v) banks should not be allowed to operate unless they meet the requirements of the Basle capital standards.

Mr. Feldman considers bank failures that occurred in Latin America. He begins by noting that systemic banking crises have occurred in the past several years in Argentina, Bolivia, Mexico, Paraguay, and Venezuela, while important cases of bank failures—without reaching systemic proportions—affected Brazil, Costa Rica, and Ecuador. With respect to crises of systemic proportions, he analyzes the causes of the bank failures and deposit runs, and examines the responses of government authorities. He compares the banking crises of Venezuela and Argentina, noting the difference between the deposit runs in those two countries. As to nonsystemic bank failures, Mr. Feldman describes cases in Costa Rica and Brazil. He points out that several lessons can be drawn from the bank failures in Latin America, including (i) the need for authorities to introduce and maintain comprehensive strategies to address problem banks and (ii) the need for authorities to strengthen prudential regulation and banking supervision in order to protect the soundness of their banking systems and, indirectly, their countries' macroeconomic stance.

Mr. Barton maintains that risk management is more important today than ever before. He explains that bank regulators must respond to the increased potential for risk in a way that is the least intrusive and least costly so that banks can thrive in today's competitive environment. In this chapter, Mr. Barton focuses on the method being employed to achieve this goal by the Office of the Comptroller of the Currency (OCC) through its "Supervision by Risk" program. His discussion of the program considers the following questions: What is Supervision by Risk? Is Supervision by Risk a change? What are the benefits of this philosophy for banks? What do bankers need to do in light of the OCC's changes? What still needs to be done by the OCC? He points out that Supervision by Risk focuses the banker and examiner on the identification and evaluation of risks across all product lines and activities. Mr. Barton notes that the

OCC has defined nine risk categories: credit, liquidity, interest rate, price, foreign exchange, transaction, compliance, strategic, and reputation risk. It has also developed a common framework for evaluating risk known as the Risk Assessment System. For each bank that it evaluates, the OCC develops a supervisory strategy based upon the evaluation, and documents and communicates its findings to the bankers. He concludes that the Supervision by Risk program will continue to evolve and that the OCC is committed to focusing on this process.

Mr. Hoffman describes a joint program used by the U.S. agencies to supervise U.S. operations of foreign banking organizations. He examines the program's main components and details the enhancement of the examination process that is embodied in the new "ROCA" rating system. This system focuses on risk management, operational controls, compliance, and asset quality. He then goes on to explain how the program enables the bank supervisory agencies, as host country supervisors, to identify supervisory concerns for communication to the banks and their home country supervisors. Mr. Hoffman contends that implementation of the program should lead to the prompt resolution of those concerns and ensure the continuance of strong overall risk management and internal control processes in the U.S. banking system. Using the case of Daiwa Bank as an example, he examines what can happen when a bank does not have adequate risk management and internal control processes in place throughout the organization. He points out that the cases of Daiwa Bank and Barings Bank exemplify the consequences of failure to observe relatively simple, "low-tech" elements of risk management and internal controls. He also emphasizes that these cases illustrate the importance of the worldwide coordination of supervisory efforts. Mr. Hoffman concludes that, given the greater likelihood that the problems of one internationally active bank will affect others, bank supervisors must have effective supervisory methods and must vigorously coordinate them.

Mr. Mattingly examines the importance that information sharing between banking supervisors has acquired in the wake of the increase in cross-border business by international banks. Noting that even the most comprehensive system of consolidated home country supervision may not be sufficient to deal effectively with internationally active banks, he reviews the cases involving the Bank for Credit and Commerce International (BCCI), Daiwa Bank, and Barings Bank. He also considers the Basle Concordat, which is a set of common principles for the supervision of banks' foreign establishments adopted by the Basle Committee on Banking Supervision. An important aspect of information sharing concerns bank secrecy or customer confidentiality (the expectation of customers that financial information will be kept confidential). To illustrate some of the legal issues raised by the sharing of confidential

supervisory information, he summarizes provisions of U.S. laws relating to the collection and dissemination of information, including the Trade Secrets Act, the Right to Financial Privacy Act, and the Freedom of Information Act. In addition, he analyzes the statutory basis on which the Board is able to share information with other supervisory authorities. In this chapter, he describes experiences of the Board of Governors of the Federal Reserve System in sharing information and the ways in which the Board has sought to balance the competing interests in this area. Mr. Mattingly also describes two multilateral initiatives concerning the sharing of information between supervisors of different industries: a joint initiative undertaken by the Basle Committee on Banking Supervision and the International Organization of Securities Regulators (IOSCO), and the Joint Forum, a working group composed of representatives of the Basle Committee, IOSCO, and the International Association of Insurance Supervisors.

Mr. Gianviti discusses basic concepts and issues relating to the resolution of sovereign liquidity crises. He begins by noting that the expression "sovereign liquidity crisis" refers to a situation where a government is unable to service the country's debt. If the debtor is a sovereign state, as a subject of international law it cannot be subjected to bankruptcy procedures or other normal legal remedies applicable to national subjects, because of its sovereign immunities. As a consequence, the only remedies available will be those that can be negotiated between the sovereign debtor and its creditors. Mr. Gianviti then analyzes several key concepts: sovereign debtor, liquidity crisis, and external debt. He distinguishes between three categories of debtors: private debtors, official debtors other than sovereign states, and sovereign debtors. Turning to the concept of a liquidity crisis, he distinguishes it from insolvency and considers the notion of solvency in the context of sovereign debtors. Thereafter, he notes that the distinction between external and internal debt is not based on the currency of payment and does not necessarily correspond to a difference between payment in local currency and payment in foreign currency. In this connection, Mr. Gianviti stresses the primary significance of the residence of the parties. He explains why attention is often given to the currency of payment in discussions on sovereign external debt. He states that the resolution of sovereign liquidity crises involves a number of different, and sometimes conflicting, considerations. He points out that, while greater attention has been given to foreign creditors and to the problem created by the shortage of foreign exchange, a sovereign liquidity crisis cannot be resolved by ignoring the situation of local creditors and the impact of local currency payments both on the budget of the sovereign debtor and on the availability of foreign exchange for all creditors, foreign or local.

Mr. Morais cites the 1994 Mexican financial crisis as a wake-up call to the international financial and political community to urgently consider improved procedures to deal with sovereign liquidity crises. He goes on to identify and analyze the deficiencies in the existing "traditional" legal framework for rescheduling sovereign debt. He addresses the essential features, relevant contractual provisions, and overall adequacy and effectiveness of the legal framework governing each of the main categories of sovereign debt—multilateral credits, bilateral credits, syndicated loans, and international bonds. Mr. Morais also examines two proposals for dealing with future sovereign liquidity crises: (i) strengthening the legal framework for negotiating with bondholders and (ii) establishing an international debt adjustment facility patterned in part on the domestic bankruptcy model.

Mr. Gordon, in a paper he presented, considers the legal remedies available to creditors in the event of a sovereign debt default. He begins by considering the meaning of the concept. He goes on to note that in order to secure an effective legal remedy against a defaulting borrower, a creditor needs two things: (i) a judgment providing that damages of a specific amount are due and (ii) sufficient assets of the borrower to attach or seize to secure the judgment. Mr. Gordon examines some of the hurdles a creditor has to clear in order to secure a judgment and have its claim satisfied, such as the applicability of the doctrine of sovereign immunity. After examining the effect of this doctrine on property of the state located in the country or abroad or on account with a central bank, he concludes by considering whether these immunities should be restricted. Mr. Gordon's discussion draws upon the statutory and case law of different countries.

Mr. Buchheit considers the process of rescheduling sovereign debt. Regarding the rescheduling process in 1982 and 1983, he recalls the then-prevailing notion that countries' external debt problems could be resolved quickly. He surmises that this refusal to acknowledge the depth of the problem was costly because temporary solutions were fashioned for what were wrongly believed to be "temporary" problems. Consequently, debt reduction (as opposed to simple debt rescheduling) was not generally used until the Brady Initiative in 1990. Mr. Buchheit draws a lesson from this state of affairs: if a solution is to come from renewed market access, then remedial measures that appear adequate to the market should be implemented to restore a country's medium-term creditworthiness at an early stage. Additionally, he addresses the impracticality of requiring unanimity of consent from all creditors to any amendment of the repayment terms. This leads him to consider creditors that are unwilling to accept a proposed debt reduction. Mr. Buchheit points out that, in some Brady-style reschedulings subject to

English law, the sovereign borrower has been asked to covenant that it will not voluntarily enter into any arrangement with a nonparticipating creditor on terms more favorable than those offered in the Brady deal unless the same terms are made available to its other lenders. Mr. Buchheit also examines the borrower's options for dealing with nonparticipating creditors. He surmises that if debt problems recur in some countries, the litigation risk to the sovereign debtors will be greater than a decade ago because of the many noninstitutional investors that are currently holding such debt.

Mr. Patrikis, in a paper he presented, surveys initiatives of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) to supervise and regulate banks' and other financial institutions' derivatives activities. He begins his discussion by examining the Federal Reserve Board's examiner guidelines and manual relating to derivatives activities. These address such issues as customer appropriateness, netting agreements, senior management oversight, and risk measurement and management. He discusses the requirements imposed by the guidelines on both examiners and financial institutions. In the latter connection, he considers the role of the board of directors and senior management, and adequate internal controls. After reviewing changes in risk-based capital guidelines and the Board's regulations, he reviews the treatment of the OCC's banking circular on derivatives activities (under the OCC's Supervision by Risk program) and the FDIC's guidance on derivatives activities. In the chapter, Mr. Patrikis highlights the *Principles and Practices for Wholesale Financial Market Transactions,* as well as initiatives of the Derivatives Policy Group, the Federal Financial Institution's Examination Council, and the Bank for International Settlements to promote enhanced disclosure and supervision of derivatives activities. He also discusses other significant federal initiatives carried out by the U.S. Government Accounting Office and the President's Working Group on Financial Markets.

Mr. Wood provides an in-depth look at how countries balance their own need to know about banking activity in order to prevent criminal activity or to properly perform their regulatory role against the privacy rights of individuals. He begins by noting that nearly all countries with developed legal systems respect bank secrecy and explains that the differences between the countries' laws focus on degree rather than substance. In essence, while there is little divergence from the rule that a bank may not disclose information about its customers to other private persons, there is significant divergence regarding the extent to which banks must disclose such information to government authorities. Mr. Wood concludes that compulsory disclosure by the banks is the prima-

ry issue in bank secrecy law. Mr. Wood goes on to provide a summary description of international attitudes on bank secrecy and disclosure, investigating the motives for maintaining and the main reasons for piercing the veil of secrecy. He classifies individual countries on a scale of low to high secrecy and identifies various sources of the law of bank secrecy, including constitutions, codes, special statutes, and case law. He elaborates on the well-known English case of *Tournier v. National Provincial & Union Bank of England*, which is followed in a large number of countries with English-based legislation, and also observes that many jurisdictions have modeled relevant codes after the original French Penal Code provisions. Mr. Wood elaborates on recognized principles regarding the scope of the secrecy duty and analyzes various exceptions to the duty, including the need to disclose information in cases of money laundering. He illustrates the concern with criminal conduct involving banking activities and the efforts to combat it on both international and national levels. In addition to discussing disclosure to bank supervisors, Mr. Wood considers disclosure to securities supervisors and tax authorities, as well as in civil litigation. In the course of the chapter, he cites national legislation and the case law of countries around the world.

Mr. Low, in a paper he presented, reviews the General Agreement on Trade in Services (GATS) financial services negotiations, which took place in 1995, and assesses their results. He begins by explaining the GATS framework within which the negotiations took place, emphasizing that a fundamental feature of the GATS is the principle of progressive liberalization. Mr. Low discusses the agreement's main obligations of the most-favored-nation principle and transparency commitments, and examines the national treatment provision. He goes on to consider the relationship between commitments to liberalize trade in financial services under GATS and policies relating to prudential regulation and to financial flows on the current and capital accounts of the balance of payments. Against this framework, Mr. Low traces the progress of the 1995 financial services negotiations and examines their results. He concludes that, in order to remove existing distortions and create a truly efficient and well-functioning global marketplace for financial services, further work is necessary in a multilateral context. Mr. Low believes that the GATS provides a unique tool for achieving the goal of providing the foundation for a liberal trading system for financial services that would benefit all countries. In an addendum, Mr. Low explains that the 1995 negotiations produced an interim agreement that remained in force until December 1997 and discusses the new, permanent set of agreed-upon commitments, which is expected to enter into force by March 1, 1999.

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Robert C. Effros

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Chapter

1 Developments at the International Monetary Fund

1A. Special Drawing Rights

FRANÇOIS P. GIANVITI

Special drawing rights (SDRs) were created by the First Amendment of the International Monetary Fund's Articles of Agreement,[1] which entered into force on July 28, 1969. Although they were created to supplement existing reserve assets, they were not explicitly recognized themselves as reserve assets by the Fund's Articles. Their main use was to be exchanged for currencies among Fund members. Some of those initial features were amended at the time of the Second Amendment (effective April 1, 1978) essentially to broaden the use of SDRs, make them the unit of account of the Fund's General Resources Account (GRA) instead of gold, and not only recognize their nature as reserve assets but expressly state that they were intended to become the principal reserve asset of the international monetary system.

Thus, with the Second Amendment, SDRs were officially recognized as a reserve asset, a characteristic that was only implicit until then. Therefore, a country's reserve assets now include four categories of assets: gold, foreign currencies, reserve position in the Fund, and SDRs. A brief comparison of these four categories of assets may be useful.

1. Gold is a traditional reserve asset and, although gold is no longer the monetary standard, many central banks hold part of their reserves in gold. Since there is no longer any official price of gold, gold reserves may be valued differently by central banks. Some use the old historic price of SDR 35 per ounce; others use the market price, which means that adjustments are made when the market price changes. Gold has two disadvantages: it is not a liquid asset, and it does not earn remuneration. For instance, a payment in gold may require a shipment from the seller to the purchaser. Alternatively, a central bank's gold deposited with another central bank may be transferred without shipment by relabeling the holdings from the seller's name to the purchaser's.

2. Foreign currencies, in contrast, are liquid assets: they may be transferred from one account to another by instructions to the depository, which may be a foreign central bank or commercial bank. Foreign curren-

cies may be invested to earn remuneration. They are valued at current exchange rates.

Both gold and foreign currencies share a common feature: they have to be purchased for value or borrowed. There is no such thing as a free distribution of gold or foreign currencies to central banks. For instance, a central bank may swap its currency for another central bank's currency, but the transaction has to be reversed within the agreed period of time.

3. A reserve position in the Fund is really a credit line with the Fund's GRA, but it is regarded as a reserve asset because its use is unconditional. It also happens to be cost free, although this is not a condition to being a reserve asset. A country that is a member of the Fund has a reserve position in the organization, to the extent that the Fund's holdings of its currencies in the GRA are below its quota. For instance, if a country's quota is SDR 100 million and the Fund's holdings of the country's currency in the GRA are SDR 75 million, the country has an SDR 25 million reserve tranche. The reason is that, because the quota must be fully subscribed in the member's currency and other reserve assets (initially gold, now SDRs or other members' currencies), whenever the Fund's holdings are below the member's quota, the member has made a net transfer of reserve assets to the Fund. This position may be the result of the way the subscription was paid or of subsequent sales of the member's currency by the Fund to other members.

Any member that has a reserve position in the Fund has the right to draw all or part of its "reserve tranche" by obtaining SDRs or other member's currencies from the Fund and replacing them with an equivalent amount of its own currency (or a security or book entry of the same amount). This right to draw the reserve tranche is said to be unconditional in the sense that the Fund cannot refuse the transaction, unless the member has been declared ineligible to use the Fund's general resources (probably as a result of an earlier breach of its obligations under the Articles). The transaction is cost free: there is no service charge or periodic charge (interest) to be paid to the Fund.

Another feature of reserve positions in the Fund is that they are remunerated, but only in part. At the time of the Second Amendment, it was agreed that reserve positions should be remunerated because they corresponded to interest-earning assets provided by each member to the Fund. However, gold that had been used previously to finance part of quota subscriptions did not earn interest and could not be remunerated. Therefore, it was agreed that for countries that were members of the Fund at the time of the Second Amendment an amount corresponding to 25 percent of their quota at that time would not be remunerated. In relative terms, this amount is now less than 25 percent of current quotas,

as quotas have been increased since 1976. Moreover, quota increases have not been uniform, which means that the unremunerated position in terms of quotas varies from country to country. This unremunerated percentage of quota is called the norm. For some countries, it is as low as 91 percent of quota; for others, more. Countries that joined the Fund after the Second Amendment were given a norm based on the average norm for other members at the time each new member joined the Fund (for example, 95 percent), and this percentage was later modified with subsequent quota increases.

4. SDRs are a relatively recent addition to reserve assets, and their creation was the result of protracted discussions. In the mid- and late 1960s, there was a growing concern that gold was no longer sufficient to finance the additional liquidity required by the growth of the world's international financial relations. Moreover, the fact that gold was essentially produced in two countries (South Africa and the Soviet Union) created uncertainties on its future production, availability, and price. The central banks were trying to maintain the official price of gold of $35 per ounce, but market prices were already higher, which could have resulted in a general devaluation of all currencies if gold remained the monetary standard. The main source of liquidity was the U.S. dollar, essentially as a result of the U.S. balance of payments deficit, but many economists believed that this deficit would not last. They thought that the end of the Vietnam War, in which the United States was heavily engaged, would restore a surplus in the U.S. balance of payments, thus generating a shortage of U.S. dollars (the "dollar gap" so dreaded at the time).

Therefore, first within the Group of Ten, later within the Fund, various proposals were put forward to create a new source of liquidity, additional to existing reserve assets, which could be created by a deliberate action of the world community and injected into the world economy in order to avoid a general deflation, but subject to some strict conditions to avoid a general inflation. Finding a name was difficult, and the most lackluster and unimaginative denomination prevailed. By analogy with drawing rights on the Fund and because the new instrument was designed essentially as a credit line among participants, the new instrument was called the special drawing right. The Fund's Articles of Agreement were amended to authorize the Fund to allocate SDRs to member countries that were willing to participate in the new scheme ("participants").

At first, the creation of the SDR appeared to be a complete success: SDR 9.5 billion was allocated by the Fund in 1970–72. The SDR was still pegged to gold at SDR 35 per ounce, because gold was the unit of account of the Fund (in the form of the gold value of the 1944 U.S. dol-

lar). However, the evolution of the world economy was not what had been expected. The U.S. balance of payments remained in deficit, and there was a surge of liquidity in the world, with inflation, as capital markets grew considerably and prices of commodities rose. Oil prices in particular increased considerably, and oil-exporting countries acquired large amounts of dollars (petrodollars), which were recycled outside the United States as eurodollars. This unexpected development cast a doubt on the continued need for SDR allocations. Nevertheless, further allocations of SDR 12 billion took place in the 1979–81 period.

Since then, there has been no SDR allocation. Consequently, countries that joined the Fund after that period have not received any SDR allocations, and some of them complain that this is inequitable. Other countries, however, feel that there is really no need at present for SDR allocations, because capital markets have ample liquidity. The debate is whether the conditions required for an SDR allocation are met, and the opinions are divided. Proposals for allocations have been made, sometimes for all Fund members—as all of them now participate in the SDR Department—and sometimes for those members that joined the Fund since the last allocation. The Managing Director has suggested to combine a general allocation to all members with a special allocation to new members. For an allocation to new members, an amendment of the Articles would be required. On March 18–19, 1996, a seminar on the future of the SDR was organized by the Fund, and the Interim Committee, at its spring session in 1996, asked that work on SDR allocations continue in order to reach a consensus. Therefore, SDRs are again very much in the forefront of the Fund's agenda.

The rules governing the creation, valuation, and use of SDRs are extremely complex, and it is not possible or even necessary to present here an exhaustive description of these rules. Only the main features will be highlighted, but before describing these main features an example of how the system operates may be useful.

Theoretical Example of How the SDR System Operates

1. Assume that agreement among Fund members is reached on an SDR allocation of 20 billion to be phased over four years. The Managing Director makes a proposal, with the concurrence of the Executive Board, to the Board of Governors of the Fund. The proposal is approved by the required majority, that is, 85 percent of the total voting power in the Board of Governors.

The allocation is then made, at no cost to them, to all members of the Fund that are participants in the SDR Department, on the basis of their

quotas at the time of their allocation. As previously noted, now all members of the Fund participate in the SDR Department.

All participants are entitled to receive an allocation. The Fund cannot discriminate among them by denying an allocation to a participant or by making allocations on any basis other than quotas. In particular, developing countries and countries in transition do not receive more or less than their quota-based share. SDR allocations are neither a form of development assistance nor limited to industrialized countries.

All participants must participate in the allocation. A participant cannot opt out unless its governor has voted against the allocation and the country notifies the Fund in writing that it does not wish to receive its share of the allocation. The reason for opting out is that participation in the SDR scheme creates some obligations, and there has been one case of opting out in the past at a time when these obligations were more likely to be effective than now.

2. Once a participant has received its share of SDRs, the participant has both an asset and a liability of equal amounts: its asset is the amount of its SDR holdings and its liability is the amount of its allocation. In the SDR Department, a mirror image will appear: by way of example, the SDR Department has a credit of 50 on the member for the allocation and a debit of 50 for the holdings. At that point the net balance is zero. The participant earns interest on its holdings and pays charges on its allocation. Since the rate of interest and the rate of charges are equal, there is no net cost again for the member as long as its holdings are equal to its allocation.

Suppose now that the participant uses some of its SDRs to pay a debt to another participant or to the GRA, or exchanges some of its SDRs for a foreign currency. Its holdings are reduced but its allocation is unchanged. The participant now has a negative balance vis-à-vis the SDR Department. Therefore, it will still pay the same charges (based on the allocation) but it will receive less interest (based on its holdings). This is true in all cases even if, for instance, the SDRs are used to make a donation: the donor will pay charges on the amount of the donation, while the recipient will earn interest on its additional holdings of SDRs.

Assume the opposite situation. A participant receives SDRs in payment: its charges will not increase because this is not an allocation, but its positive balance will entitle the participant to additional interest because its holdings have increased.

These basic rules of SDR accounting are unfortunately not always known, which may explain why some generous proposals for SDR donations to indebted countries have eventually failed when the potential

donors realized that they would bear not only the voluntary loss of reserve assets but also the cost of additional charges on the amount donated.

3. The last step in this theoretical example is cancellation. Pursuant to the same procedure used for allocations, the Fund can cancel all or part of existing SDRs. The cancellation will be made in proportion to existing net cumulative allocations, without any discrimination among members. There is no opting out for cancellations.

Once a decision to cancel has been taken, the cancellation is automatic for participants whose holdings exceed or are equal to their share of canceled SDRs. Other participants must eliminate their negative balance as promptly as their gross reserve position permits. Therefore, there is at least a possibility of delay in the cancellation of those SDRs, since they have to be acquired by the participant that has a negative balance. There is even a risk that the participant will eventually fail to fulfill that obligation and will never return the value of the SDRs received in allocations.

A similar situation may arise if a member withdraws from the Fund: its participation in the SDR Department is terminated, and its SDR allocation is canceled.

Finally, the SDR Department may be liquidated, and all SDR allocations would then be canceled: some participants will have a positive balance while others will have a negative balance.

In all of these situations, there is a risk of loss if a participant does not return an amount of SDRs equal to its SDR allocation. The risk of loss is not borne by the Fund. When the SDR Department is liquidated, the loss will be shared among all participants with a creditor position, that is, those whose holdings of SDRs exceed their respective allocations. This consequence derives from the total separation of assets and liabilities between the General Department, where the Fund holds assets and incurs liabilities, and the SDR Department, which is only administered by the Fund and where the assets and liabilities are those of the participants.

This example will help to understand the nature of the SDR as an original type of reserve asset.

Functions of the SDR

The SDR has two functions. It is a unit of account and a reserve asset.

Unit of Account

The SDR is the unit of account of the Fund's GRA. All Fund holdings of currencies in the GRA are expressed in SDRs, and their value must be

maintained in terms of SDRs. If a currency depreciates, an additional amount must be credited to the Fund by the member, usually in the books of the central bank or in the form of security or book entry. If a currency appreciates, the Fund must return part of its holdings to the member. In both cases, the SDR value of the currency holdings will remain unchanged in terms of SDRs.

The SDR is also the unit of account for certain other purposes. For instance, it is the unit of account of the Structural Adjustment Facility (SAF), within the Special Disbursement Account of the General Department. It is the unit of account of the Enhanced Structural Adjustment Facility (ESAF) Trust, which is an administered account of the Fund outside of the General Department.

As a unit of account, the SDR is also used by various international organizations (the African and Asian Development Banks and the International Development Association), in bond issues and loan agreements, and for purposes of certain international treaties.

The value of the SDR is determined by the Fund on the basis of a basket of the five freely usable currencies.[2] It is the sum of the following amounts:

U.S. dollar	0.582
Deutsche mark	0.446
Japanese yen	27.200
French franc	0.813
Pound sterling	0.105

On May 7, 1996, the U.S. dollar value of the SDR was about $1.45 (exactly $1.4497).

Reserve Asset

At the time of the Second Amendment, two provisions were added to the Fund's Articles that both state the objective of making the SDR the principal reserve asset in the international monetary system.[3] The meaning of this objective is not altogether clear, but it can be explained by the *travaux préparatoires* of these provisions. The intention was that the SDR would replace gold in the monetary system. In other words, it would be the anchor of the system, not in terms of quantity but in terms of quality. It would be a desirable asset, valued and held by central banks. There was no intention, however, of preventing countries from holding other reserve assets or of making massive allocations of SDRs to replace other assets. Rather, it was expected that central banks would be less willing to part with SDRs—ideally more valuable than gold—than with other reserve assets. This explains why the Articles of Agreement imposed an

obligation on participants to reconstitute, at least in part, their holdings of SDRs, an obligation that has since disappeared. This also explains why consideration was given, after the Second Amendment, to the establishment of a substitution account, which would have allowed countries holding dollars and other currencies to replace them with SDRs, but this proposal failed.

In any case, it is clear from the record that the objective of making the SDR the principal reserve asset was not regarded as a basis for SDR allocations, since these allocations are governed by specific conditions stated in other provisions of the Articles of Agreement. It may be noted, however, that shortly after the Second Amendment, when a second SDR allocation was under discussion, the point was made that, if the total amount of allocated SDRs fell to a negligible level in total reserve assets, the objective of making the SDR the principal reserve asset could not be met. Therefore, although the objective was of a qualitative nature, it would have quantitative implications.

As a reserve asset, the SDR offers a number of original features.

First, unlike gold and coins or banknotes, it is not a physical asset. It is not legal tender in any country. SDRs are book entries in the SDR Department of the Fund. SDRs can only be used among participants in the SDR Department, the Fund itself, and other holders prescribed by the Fund (for example, the World Bank, the Bank for International Settlements, and the like). Their use even among participants, the Fund, and prescribed holders is somewhat limited by the Articles of Agreement: they can be used for payments or exchanged for currencies of equivalent amount, and they can also be used for various operations, such as donations or swaps, prescribed by the Fund. The Fund itself can only hold SDRs in the GRA, not, for instance, in its administered accounts, even those where SDRs are used as a unit of account (the ESAF Trust).

Second, SDRs are created by the Fund, but they are not issued by the Fund. Unlike currencies, which are issued by central banks for value received and constitute liabilities in their balance sheets, SDRs are allocated by the Fund without any value received, and they are not liabilities of the Fund. As previously explained, the risk of ultimate loss is not borne by the Fund but by participants with creditor positions. Therefore, SDRs are really what their name says: they are credit lines among participants. This explains the contrast between a payment in foreign currencies and a payment in SDRs. A central bank making a payment in a foreign currency parts with an asset and will lose the interest on the asset if it was invested, but will not have to pay interest unless the foreign currency was borrowed. In contrast, a central bank making a payment with SDRs will

have to pay charges if its holdings are reduced below its allocation: it has a debtor position vis-à-vis the SDR Department, as in the case of a payment in borrowed currency.

Third, operations and transactions in SDRs take place normally by agreement among participants and with the Fund or other holders. However, the Articles also contemplate the case where a participant could not find a counterpart willing to exchange its SDRs for currency. In that case, the Fund can designate a participant to provide currency for those SDRs. These transactions by designation are no longer necessary in practice, but this feature of the SDR system shows that basically SDRs are credit lines among all participants, on a multilateral basis, in order to ensure the full liquidity of the SDR as an asset.

Finally, SDRs can be canceled, just like credit lines can be terminated. The difference is that the decision to cancel is not made by individual creditors but by the Fund and in proportion to net cumulative allocations.

Without being facetious, the closest analogy to SDRs is Monopoly money. It is distributed at the beginning of the game to all players, because without money there is no game, and it is returned at the end. The difference is that in the SDR Department the "play money" can be used to buy real assets and discharge real liabilities and, at the end, real value must be returned if the allocated SDRs have been spent.

Allocations of SDRs

The general features of SDR allocations have been described in the theoretical example above, except one that is essential: the substantive conditions for an SDR allocation. Article XVIII, Section 1(a) of the Fund's Articles of Agreement sets forth these conditions:

> In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world.

The major difficulty and the most controversial element in this provision is the meaning of "long-term global need." Many attempts have been made to define this concept, but, even if a definition were adopted, there would still be a question of judgment as to whether at a particular moment it can be concluded that there will be such an actual long-term global need.

On the meaning of what constitutes a long-term global need, there have been innumerable discussions, but no definitive agreement has been

reached. The only certainty is that there is no mathematical formula to answer the question. Some even doubt that, in a world of rapidly growing capital markets, there could ever be a long-term global need justifying SDR allocations, because reserves can always be borrowed from the markets. In response, others argue that some developing countries have no access to those markets or can only borrow under expensive conditions and for short periods, while an SDR allocation would provide them with the reserves they need. The response to the response is that the need of some developing countries is not a global need and that the cause of their problem is not the lack of available liquidity but their own lack of creditworthiness.

Without trying to resolve these fundamental problems, a few points can be made.

First, a distinction must be made between the finding of long-term global need and the decision to allocate SDRs. There may be a finding of need without a decision to allocate, for instance, because an increase in reserves other than SDRs is expected. Here, the objective of making the SDR the principal reserve asset will be taken into account, not as a substitute for need, but to decide, once a need has been found, whether an SDR allocation is the proper answer.

Second, the concept of need must be understood in light of the objectives of the provision: attainment of the Fund's purposes and avoidance of economic stagnation and deflation, as well as excess demand and inflation in the world.

Third, at the time of the second SDR allocation, the report to the Board of Governors proposing the allocation stated the preference for owned reserves resulting from SDR allocations over borrowed reserves obtained from capital markets, as borrowed reserves are subject to refinancing. This consideration was included in support of the finding of long-term global need, but it would have more appropriately been made in support of a preference for SDR allocations over certain other forms of reserves. Regrettably, the distinction between the finding of need and the choice for an SDR allocation, initially made in the report, disappeared at the final stage and created some confusion.

Fourth, when assessing the need to supplement reserves, the concept of gross reserves has been used, although some support for using the concept of net reserves has been expressed.

Fifth, the term "global" means that an overall assessment must be made in terms of world reserves and need. The particular need for reserves of a group of countries is not relevant. In particular, the point was made at the time of the second SDR allocation that an inequitable

distribution of reserves among countries, some of which had no access to capital markets, should not be taken into account.

Sixth, access to Fund credit is not a substitute for reserves, because reserves are unconditional while Fund credit is conditional. This point was also made at the time of the second SDR allocation, but again it is not relevant to the finding of need but rather to the discussion on how to meet the need, that is, whether or not an allocation of SDRs is the appropriate measure.

The ongoing and inconclusive discussions since 1981 on what constitutes a long-term global need and whether at any given moment the finding can be made has led to some proposals for amendments of the Articles.

Proposals for Amendments

Various types of amendments have been proposed to ameliorate the SDR in order to make it a hard asset. This would require a new definition, probably based on the price of the stronger currencies, at any given time, in a specified basket. The consequence could be a lower interest rate on SDR-denominated obligations, since the principal would be better protected against inflation.

Most proposals, however, have focused on the conditions required by the Articles for SDR allocations. A few may be mentioned. First, the concept of long-term global need could be defined on the basis of a mathematical formula; for example, as a percentage of world trade. A 10 percent increase in world trade would justify an additional 10 percent allocation to maintain the relative importance of the stock in SDRs in the world economy.

Second, SDR allocations could be linked to changes in quotas; any quota increase would trigger an SDR allocation in the same proportion. In that case, SDR allocations to each participant would be based on increases in the participant's individual quota.

Third, in the 1970s consideration was given to special allocations to developing countries ("the link"). More recently, there was widespread support for an "equity allocation" to new members of the Fund that had not participated in previous SDR allocations. However, any allocation to a specific country or group of countries would require an amendment of the Articles, since the rule is that all allocations are made on the basis of quotas among all participants in the SDR Department.

In order to achieve some kind of equity allocation without an amendment, it was suggested to use the Fund's power to cancel existing SDRs:

all existing SDRs would be canceled, and they would be immediately reallocated among all participants, including new members, on the basis of current quotas. This proposal had one major disadvantage: some early participants would not receive the same amount of SDRs that they had before the cancellation, because the existing SDRs would be reallocated among a greater number of participants. Even if the cancellation were combined with an additional allocation, those participants would be deprived of their right to participate in the new allocation without losing their existing allocations. On legal grounds, the proposal was not acceptable, because, in order to cancel SDRs, the Fund had to find that there was no longer a need for them and the Fund could not, in good faith, make such a finding and at the same time find that there was a need for a new allocation. The proposal was a clear case of *détournement de pouvoir* where the Fund would use its powers to cancel and allocate in order to circumvent the rule that SDR allocations cannot be redistributed by the Fund among participants. The proposal was abandoned.

Fourth, as a substitute for the cancellation-reallocation technique, it has been proposed to amend the Articles in order to provide for a special allocation to new members. This "equity allocation" has found widespread support, but countries that support a general allocation on the basis of the present Articles of Agreement have taken the view that there is also a long-term global need justifying such a general allocation and have made the general allocation a condition for their approval of the amendment and the "equity allocation" to new members.

All of these proposals have one element in common: they preserve the unconditional nature of SDR allocations in the sense that either all participants or a designated group will receive the allocations. Other, more radical proposals have been put forward. For instance, SDRs could replace currencies in the GRA: the Fund would hold SDRs instead of the currencies paid by members for their quota subscription, and SDRs held by the Fund would be either borrowed or bought for their own currencies by member countries. A less radical system would be for the Fund to retain its holdings of currencies, but the Fund would also make temporary allocations of SDRs in order to supplement its holdings of currencies. In both systems, the sale or allocations of SDRs would be subject to the conditions governing the use of Fund resources. The objection to these schemes is that they would change the nature of SDRs and SDR allocations. They would either replace or compete with the current use of Fund resources, and they would negate the traditional distinction between unconditional assets such as SDRs and conditional assets such as credit tranche purchases from the Fund or loans from the ESAF Trust.

Most probably, the time has not come for such radical changes and the current discussions will focus on a possible compromise combining an equity allocation to new participants with a general allocation to all participants.

Addendum

On September 23, 1997, the Board of Governors of the Fund adopted a resolution approving a proposal of the Executive Board for amending the Fund's Articles to allow for a special onetime allocation of SDRs so as to equalize members' ratios of cumulative allocations to their Ninth Review quotas at approximately 29.32 percent.[4] In order to enter into force, the amendment will require acceptance by three-fifths of the members of the Fund, having 85 percent of the total voting power.[5]

1B. On Being a Lawyer in the International Monetary Fund

WILLIAM E. HOLDER

Introduction

Societies, as well as organizations, ascribe different roles to lawyers. As international organizations have grown in number, diversified in function, and matured in form, interest in the actual situation of the lawyers in such organizations has increased. The International Monetary Fund is both active (in the pursuit of its objectives and functions) and mature (at 50). As the primary global organization responsible for the international monetary system, it is staffed mainly by economists. In this milieu, therefore, it is of interest to inquire: What does a lawyer do? When, how, and with what effect?

In order to answer these questions, first it is useful to spell out the objectives, structure, and functions of the Fund. Legal activities will necessarily reflect these features. Second, it might be informative to sketch the spread of legal tasks that are carried out by the Legal Department at this time. Third, and to flesh out the inquiry, some features of the legal function will be identified: Who are the clients? What form does legal advice take? Where is the law found? Finally, some issues of a broader nature will be raised for purposes of appraisal and reflection.

The Fund and Its Functions

The Fund

The following is an overview of what the Fund does and how it does it.

The Fund is an intergovernmental, international organization, whose authority and power derive from its constitutional document, the Articles of Agreement.[1] These Articles were drafted by the World War II allies in 1944 at the same time as, but not as a component of, the negotiations leading to the United Nations (UN). The final negotiations, held at Bretton Woods, New Hampshire, produced both the Fund and the World Bank—thus, the "Bretton Woods Institutions."

Under the Articles of Agreement, membership in the Fund is open to all countries, subject to the decision of the Fund on terms and conditions.[2] Today, membership is essentially global (182 members). The Soviet Union, despite its participation at Bretton Woods, decided at that time not to become a member; but Russia and the other 14 components of the former Soviet Union have now joined.

As a worldwide organization with global responsibilities, the Fund is a distinctive actor in the international system—apart from its members—and, as such, exercises international legal personality. In addition, the Fund is also a specialized agency of the United Nations, having entered into the requisite agreement with the United Nations.[3]

The Articles of Agreement determine the decision-making structure of the Fund: A Board of Governors, composed of a Governor appointed by each member (and an Alternate Governor), concerned with basic policies and constitutional decisions, meeting annually; an Executive Board, consisting of 24 Executive Directors, some appointed by the largest members and some elected by their constituent countries, meeting constantly in Washington, thus constituting an active arena of intergovernmental consultation; and the Managing Director and staff. The Managing Director serves both as Chairman of the Board of Directors and as chief of the staff.

Functions

The functions of the Fund are set forth in the Articles of Agreement.

Article 1 of the Articles of Agreement sets out the purposes of the Fund in generic but incisive terms:

- to promote international monetary cooperation;
- to facilitate the expansion and balanced growth of world trade;
- to promote exchange stability, including the avoidance of competitive exchange depreciation;
- to assist in the establishment and maintenance of a multilateral system of payments;
- to make financial assistance available to members, thus assisting members to overcome their balance of payments difficulties; and, thereby,
- to help shorten both the duration and magnitude of payments imbalances between countries.

The Articles then deal with the functions designed to achieve those ends. A primary function is to administer a code of conduct with respect to exchange arrangements of members in order to establish and maintain fair exchange arrangements and stable exchange rates. This function was specifically delineated in the Second Amendment (in 1978) in order to replace the par value structure of the original Articles. Article IV imposes certain obligations on members; in turn, the Fund assumes the responsibilities of "oversee[ing] the international monetary system" and

"the compliance of each member with its obligations" and is called on to "exercise firm surveillance over the exchange rate policies of members."

Performance of this function of "surveillance" calls for the continuous collection of information by the Fund, regular contact between the Fund and its members, analysis of the underlying national financial and economic policies, the production of papers by the staff and discussions by the Executive Board, and dialogue between the national authorities and the Managing Director and staff. The surveillance function involves a constant interchange between the Fund and each member, and review of national action in the context of interactions with others and the broader international interests.

In order to foster a multilateral system of payments for current international transactions between members and the elimination of foreign exchange restrictions, members are obliged not to impose exchange restrictions on current international transactions, and to avoid multiple currency practices and discriminatory currency arrangements without the approval of the Fund,[4] although restrictions maintained at the time of membership may be continued (and, by definition, those on capital transfers).[5] Accordingly, this function calls for constant identification by the Fund of each member's exchange laws and practices, and the resulting exercise of the Fund's regulatory jurisdiction in this respect.

To assist members to respond to their balance of payments problems, and to enable them to fulfill their obligations under the Articles, the Fund provides foreign exchange, primarily from the currencies provided by members in the form of subscriptions, in order to help members overcome their external difficulties.

In this respect, the Fund has developed extensive policies and practices ("facilities") for rendering this financial assistance, with a corresponding range of entitlement ("access") and conditions governing that entitlement ("conditionality").

In recent years, financial assistance has been granted primarily within two major avenues. First, for utilization of the general resources of the Fund, the traditional framework is the stand-by or extended arrangement. Under this technique, financial assistance is available to a member, pursuant to a credit line, over a period of 1–4 years, in support of the member's stated financial and economic policies, and in accordance with a member's progress (and to be reversed over 4–10 years). Second, for the 70 poorest countries, loans are available at concessional terms for similar stabilization purposes, under the Enhanced Structural Adjustment Facility (ESAF) Trust.

An additional area of activity of the Fund today concerns the operation of the regime of special drawing rights (SDRs), a scheme introduced by the First Amendment of the Articles in 1969, by which the Fund may supplement members' reserves by allocating, on a deliberate and periodic basis, the reserve asset called the SDR.[6]

The latest allocation of SDRs was decided on in 1979 and completed in 1981. Allocation requires a threshold judgment that there is a global need to supplement existing reserve assets and be approved by 85 percent of total voting power. Since 1979, the required consensus of members for a further allocation has been absent, but the issue remains on the active agenda of the Fund.[7]

In recent years, the Fund has increased its efforts to provide technical assistance to its members for areas within its competence (primarily, fiscal, monetary and balance of payments policies, banking, exchange and trade systems, government finance, and statistics).[8] This assistance—provided to members requesting it—is provided by staff members an outside experts, and usually involves visits to the country for discussions with national officials, followed by the preparation of studies, recommendations, and the identification of a timetable for implementation.

Finally, the Fund—like many international institutions—publishes extensively concerning its activities: an *Annual Report*, an *Annual Report on Exchange Arrangements and Exchange Restrictions*, the *World Economic Outlook*, several statistical publications, and a steady stream of books, articles, and pamphlets.

Legal Activities

Most, if not all, international organizations have a legal department, usually headed by a General Counsel. In the Fund, the Legal Department is made up of 25 lawyers—ranging in seniority and experience, and, reflecting the multinational character of the institution, drawn from different national legal backgrounds. In fact, the Legal Department is the smallest of the Fund's 22 departments: to perform its functions, the Fund employs about 2,700 people, many of whom are economists.

The Legal Department was one of the first departments established at the beginning of the Fund in 1946, although lawyers had played only a supporting role during the negotiation of the Articles of Agreement in 1944. From those early days, therefore, it was accepted that the "legal perspective" was a necessary part of decision making. Since then, the Department has contributed to practically all of the Fund's activities.

For organizational and presentational purposes, the legal work in the Fund can be described as falling within four functional categories: general legal issues, country-specific issues, administrative affairs, and technical assistance.

General Legal Issues

The broader legal issues faced by the institution comprise a class that may be categorized as "general legal issues." Such issues include the most basic constitutional questions, involving matters of scope of power and permissibility of decision and action, the formulation of general decisions to project policy intentions, the drafting of basic instruments, the analysis of new legal issues and proposed initiatives, and relations with other organizations.

The Articles of Agreement are a constitutional document; under the Articles, the Fund is created as an entity of limited authority. Proposals for action, therefore, must be appraised for their legality. At the same time, a constructive approach requires a search for alternative strategies that may both satisfy legal standards as well as achieve the policy objective. However, in the event that constitutional difficulties cannot be overcome, an amendment to the Articles might be considered. At that point, examination of the scope and integration of the proposal with the existing Articles becomes paramount. Finally, once the draft amendment is settled, submission of an amendment will be accompanied by a detailed explanatory commentary to the Board of Governors. Amendments to constitutional charters, however, are not common; not only are amendments treated with solemnity, but for many countries parliamentary approval is required. Nonetheless, currently two amendments are under review by the Executive Board: one to allow for a special and additional allocation of SDRs, the other to increase the Fund's regulatory authority over capital movements.

Allocations of competence between organs and procedures for decision making provoke a variety of legal issues. In December 1992, the Fund decided that the Socialist Federal Republic of Yugoslavia had ceased to exist, that it had been replaced by five new states, and that these five states should be offered membership in the Fund as successors to the original single member. That decision necessarily involved the issue of the appropriate level of authority. The Executive Board accepted that, the question not being a matter reserved to the Board of Governors, it was the authorized organ as a matter of general delegation. Issues of procedure are more pervasive. After the Second Amendment, there are numerous types of decisions calling for special majorities; the sale of gold by the Fund, for example, requires an 85 percent majority of the total voting power. In

deciding upon the appropriate majority, the categorization of the actual decision then becomes crucial.

The formulation of new policy decisions can be particularly challenging. The Fund's existing legal system must be reviewed and analyzed so that the proposal can be assessed for legality and consistency. Specifically, the new policy decision must be drafted so as to achieve the objectives of the proposal, and at the same time be sufficiently clear to members (in terms of their rights and obligations) and to Fund staff (in terms of application of the measure).

The Fund, of course, is only one among many actors in the international legal system. Another dimension is added by the Fund's relations with other international organizations, such as the UN, the World Trade Organization (WTO), or the Organization for Economic Cooperation and Development (OECD). Traditionally, some organizations are close and open to cooperative (if at times competitive) behavior—as is, for example, the World Bank in its relations with the Fund. In other cases, organizations are entwined by their charters and other formal arrangements. With the WTO, for example, specific provisions build on the earlier General Agreement on Tariffs and Trade (GATT) experience of recognizing the Fund's jurisdiction over exchange restrictions, on the one hand, and of the Fund's contribution in the case of exchange restrictions for balance of payments purposes, on the other hand. At this time, to bolster the GATT experience, the Fund is negotiating a formal agreement with the WTO, which spells out the nature and scope of the cooperation of the two organizations through their organs and their staffs.

In these endeavors, the Legal Department at times prepares its own papers to serve as legal opinions. More frequently, lawyers work with other departments in order to produce joint papers, especially for the Executive Board. Finally, the Legal Department regularly reviews virtually all of the policy papers authored by other departments, for example, on surveillance, use of Fund resources, financial structure, and SDRs, in order to ensure respect for legal standards and the explanation of applicable principles, before the papers are issued to the Executive Board for discussion and decision.

Country-Specific Issues

The Legal Department is responsible for the drafting of all country-specific decisions. These include, in particular, Article IV consultation decisions and those on the use of Fund resources (including any associated arrangement).

As mentioned, the Fund's regulatory jurisdiction focuses especially on each member's exchange rate policies and exchange restrictions, usually

in the context of the annual Article IV consultation report to the Executive Board. For each of the Fund's 181 members, therefore, the exchange system of each member must be identified, understood, and explained; specifically, it is for the "country lawyer" to identify any restrictions, in order that they may be included in the relevant Article IV consultation report to be considered by the Board, as appropriate, for approval. In this regard, the Fund's principles and jurisprudence have to be explained—and, at times, defended—both to the member countries and to the Executive Board. As part of its expertise, when a member is considering relinquishing its reliance on the transitional processes of Article XIV, thereby "accept[ing] the obligations of Article VIII,"[9] the Legal Department undertakes a full and intensive review of the exchange system.

A major activity of the Fund is the provision of financial resources to its members to assist in their balance of payments stabilization. Approximately 90 members currently are pursuing adjustment programs in conjunction with the Fund.

The original expectation of the Articles was that the use of Fund resources was to be quite simple. That is no longer the case. First, different policies or windows ("facilities") have been established to respond to different balance of payments problems. Second, there are two major means of assistance, the first drawing on the General Resources Account, the second drawing on the additional resources of the Structural Adjustment Facility or the ESAF. Third, as is well known, the Fund must be assured of the efficacy of the underlying economic and financial reform ("conditionality"), entailing the use of performance criteria, phasing, and regular reviews. In the case of Russia, for example, the new extended arrangement makes purchases subject to monthly reviews. All of these technical elements require understanding of policies and practices within a fabric of documentation that is unique to the Fund. It is for the lawyer to ensure that the Executive Board acts within the constraints of the Articles and the policies of the Fund, that the interests of both the Fund and the member are protected, and that the documentation, including the Board decisions, are in order.

In recent years, country-specific issues have also included the negotiation of an unprecedented growth of membership—35 new members since 1992. Membership is taken seriously by all concerned. On the side of the country, membership involves it in a new and intense relationship, calling for detailed scrutiny of its domestic affairs, disclosure of elements of its economic and financial system previously kept secret, and a variety of new obligations. On the side of the Fund, the membership seeks assurance that the country will behave in accordance with the applicable rules, and that, in the terms of the Articles, the applicant is legally in a position

to accede to the treaty and to carry out its obligations. As a participant in this reorientation, the lawyer's job is to explain the linkages of membership to the country and its new international obligations, as well as the policies and procedures of the Fund, and thereby to assist the country to draft the necessary membership legislation. Often, the exercise is straightforward, especially as credibility is established and issues explained. At times, however, more complex legal issues have to be resolved. For example, Bosnia and Herzegovina became a member of the Fund on December 20, 1995. Constitutionally, the governmental authorities were acting under the provisions of the Dayton Accord and, in particular, pursuant to the new constitution that entered into effect at the time of the Accord. Accordingly, the Fund had to rely on the transitional provisions of the Constitution in order to clarify, with the authorities, the appropriate procedures and, in particular, the officials authorized to act for the country.

Technical Assistance

The general growth of the Fund's technical assistance program is reflected in the enlarged involvement of the Legal Department; today, more than one quarter of the Department's resources are devoted to technical assistance.

Necessarily, the Fund's legal technical assistance is associated with monetary, financial, and economic matters; traditionally, it is focused on three major areas: (i) the exchange system—especially related to exchange restrictions, exchange liberalization, and international payments; (ii) central and general banking; and (iii) taxation. In practice, this includes the review of proposals for new legislation, in the context of the political and legal aspects of the country, and the production, in close collaboration with a working group of the authorities, of comprehensive new laws. In this venture, the Fund's lawyer is expected to contribute a perspective drawn from comparative experience, to clarify the proposed scheme, and adapt it to the changing demands and the prospect of enactment. In addition, the enactment of the legislative measure may be tied to the member's program of financial and economic reform; when the measure is identified with a required prior action or a required performance under a Fund-supported program, its significance increases.

Administrative Legal Services

In Fund parlance, "administrative legal services" refers to the more practical aspects of the Fund's legal relationships—both internal and external. Such functions are part and parcel of all international organizations.

Reflecting its legal personality and specified capacities, the Fund engages in a variety of activities in the "real" legal world; for example, it engages in contractual and other relations with private parties, pursues legal claims, and may be subjected to suit.

Second, under the Articles the Fund is immune from judicial process, and its staff and officials are protected in the performance of official functions.[10] Within national courts, therefore, the Fund cannot be sued without its consent. That immunity, however, can be waived by the Fund. Similarly, officials and employees are entitled to the functional immunity referred to in the Articles and confirmed and expanded in the UN Convention on the Privileges and Immunities of the Specialized Agencies.[11]

Third, there is the matter of relations between the Fund and its staff. What law governs the employment relationship? If there is a dispute between the Fund and a staff member, how is it settled? Like other international organizations, the Fund has established different levels of decision for the resolution of such issues, in the form of a less formal and nonbinding Grievance Committee, and an adjudicatory, binding Administrative Tribunal, which allows the legality of regulatory and individual decisions to be tested.

Finally, the Fund as an employer conducts a pension scheme for its staff members, bringing different demands for rules, procedures, and judgments. On the one hand, the assets of the Plan are invested in accordance with the directions of an Investment Committee; the result is a mix of asset classes invested globally through more than 35 hired money managers. On the other hand, it is the Administration Committee's job to apply the Plan across an assortment of individual situations.

All of these practical dimensions of the Fund take place in a legal context, with serious (and at times financial) consequences. Until now, they have been handled in-house by the Legal Department. In this way, the lawyer is expected, therefore, to protect the interests of the Fund, to assist other departments (particularly the Administration Department) in the pursuit of their functions, and to act as counsel for the Fund in arbitration and litigation proceedings.

The Context of Legal Advice

The Clients

The work of the Legal Department is demand driven from a variety of sources. Unlike in the case of a corporate lawyer, or even a governmental legal adviser, at the Fund requests for legal advice are relatively disparate and uncoordinated.

- Members of the Fund, more formally at the level of Governors or Ministers, often acting through the respective Executive Directors, seek advice of the Legal Department on particular issues; for example, in the course of the Annual Meetings and other meetings, when issues assume a higher and more focused profile, and when a lawyer is asked to visit the country to explore a particular legal issue.

- The Executive Board, as its name implies, is the organ of the Fund responsible for much of the Fund's deliberation and decision making. It meets on a continuous basis in Washington, D.C. As part of the Executive Board's deliberation of any matter, a legal question can arise. Often, the General Counsel or another senior lawyer responds immediately; at times, however, a more sustained written legal opinion is agreed on. For both more general policy decisions and the country-specific decisions, it is expected, therefore, that a lawyer will be available to explain the legal dimension to the Board and to guide its deliberations.

- Executive Directors, who make up the Executive Board, consult the Legal Department as they consider it useful. This occurs so as to enable them to obtain or better understand a legal view, especially during the preparation of a presentation to the Board on an agenda item. It also occurs so as to explain matters to a concerned member.

- The Managing Director, assisted by three Deputy Managing Directors, regularly calls for legal input. As chief of the staff of the Fund, the Managing Director is responsible for positions taken and advice given; as Chairman of the Executive Board, he is responsible for recommending proposals to the Board; as Managing Director, he is a participant in international discourse and initiatives at the highest political level. For these endeavors, the General Counsel is expected to contribute on an ongoing basis.

- Other Departments and staff, either by tradition, direction, or in the search for assistance, turn to a lawyer. Thus, as mentioned above, virtually all papers written for submission to the Executive Board are passed to the Department for comment. Meanwhile, as part of this process a Department or a staff member can seek legal clarification at any time.

- External inquiries are common. These range from friendly collaborators in other international organizations, to commercial agents and adversaries, to lawyers in practice facing international financial and Fund-related issues, and to lawyers and courts requesting a Fund view pursuant to Article VIII, Section 2(b) of the Articles of Agreement.

Forms of Legal Advice

Legal advice is given in different ways, ranging from the formal to the less formal.

The more formal legal opinions cover a spectrum. First, the Executive Board might ask for a full analysis of a legal position. In that case, the General Counsel directs the lawyers of the Department in the research, drafting, and production of an opinion under the rubric of an "Executive Board paper." Normally, the Board will then discuss the issue. Similarly, a report to the Board of Governors on a matter for decision at that level, such as an amendment for the Articles, will be accompanied by a legal analysis (or "commentary").

Second, the individual client may request or the issue may deserve a written formulation. That opinion, in turn, becomes part of the "law" of the Fund, to be identified, retrieved, and referred to in the future as a "precedent."

Third, in the same way, the legal staff's contributions at the Executive Board in the form of oral statements and replies to questions become part of the record. Extensive minutes of the Board meetings are kept to guide action in the future.

Less formal advice follows a similar diversity. First, as noted, almost all draft Executive Board papers emanating from other departments, both general policy papers and periodic reports on the one hand, and country-specific matters on the other hand, benefit from legal review and clearance. In addition, the Legal Department may be asked to review the more formal statements and speeches, as well as certain publications of the institution, and communiques and press releases.

The Fund, like other institutions, resorts to committees, working groups, task forces, and so on. In such situations, a legal perspective can guide the discussion on issues of substance and technique.

Finally, there is the ubiquitous telephone inquiry from new or established clients.

Corpus Juris of the Fund

To this interplay of legal activity, further questions might be asked: What law governs these questions? Does the Fund lawyer turn to some equivalent of *American Jurisprudence*? The response is not quite so simple, but neither need it be elusive. There are, in the Fund's practice, ample "sources" of law.

- The Articles of Agreement are the constitutional charter of the Fund. The Articles lay down the Fund's juridical personality, its pur-

poses and functions, its institutional structure, its privileges and immunities, and, thereby, the rights and obligations of members.

- The Board of Governors adopts decisions ("resolutions") on important matters reserved to it, either in the form of general decisions, such as the Fund's By-Laws and the rules for the election of Executive Directors, or in the form of individual decisions, such as the terms and conditions for the admission of new members.[12]
- Executive Board decisions are numerous and diverse, being made up of general policies on the Fund's activities, more detailed prescriptions ("Rules and Regulations"), and country-specific decisions (for example, approval of a Stand-By Arrangement or conclusion of an Article IV consultation).[13]
- Within international organizations, practice can be prescriptive, especially when acted on by members and accepted by the Executive Board as authoritative. Past interpretations and legal opinions, meanwhile, are guarded carefully by the Department and can greatly influence legal positions and the course of decision making.
- As a public international organization, the Fund relies also on principles of public international law and, more specifically, on principles governing international organizations, for example, with respect to treaty interpretation, the definition of what is a "country" eligible for membership and recognition of states and governments. Similarly, "the general principles of law" can play a role, involving, therefore, extensive comparative law investigation.
- National law, especially through the form of comparative law, is also analyzed and respected, according to the context. By way of example, it could help to elucidate concepts of setoff and retroactivity.
- International agreements may be particularly relevant, for example, the UN Convention on Privileges and Immunities of the Specialized Agencies.[14]

Observations

In light of this description of the Fund's activities in general and the lawyer's participation in these activities more specifically, some general observations about "being a lawyer in the Fund" might be made.

First, a lawyer in the Fund participates relatively fully in the Fund's decision-making process: the formulation of policy proposals, the conversion of policy into authoritative rules, the interpretation and application of rules, and review and termination of rules.

Nonetheless, the lawyer's involvement varies according to the situation. On major policy initiatives and matters in which legal complexity is apparent, the Department works in close association with others. In some activities, tradition sometimes governs the lawyer's involvement or exclusion. There is no readily accepted definition of "legal issues"; sometimes, therefore, legal matters are necessarily (at least in terms of resources) handled by nonlawyers. Significantly, for example, the formulation of adjustment programs and the conduct of the staff's Article IV discussions normally proceed without the presence of a lawyer. It follows that sometimes a lawyer's engagement will be as a reaction to events rather than in terms of problem prevention.

A second comment relates to the loyalty of the lawyer; in other words, whose lawyer is he? In the domestic situation, the lawyer's allegiance is more easily identified, such as an advocate for a party in the adversary process, as an adviser to a foreign office pursuing the identified national interest, or as a judge adjudicating a disputed claim.

Clearly, in the structure of the Fund there might at times be a certain tension. On the one hand, the Legal Department is just another of the Fund's many segmentations (22 departments, bureaus, and offices) advising the Managing Director as he serves as chief of the operating staff. On the other hand, the General Counsel cannot reasonably be expected to change his legal advice upon command. In the Executive Board, similarly, Executive Directors look to the Legal Department as giving expert advice in an objective and essentially definitive fashion. Yet, at times, particular Executive Directors may contest the legal view; this is quite possible, for instance, when national interests are seen to be at stake or when national legal authorities have an established position despite the apparent correctness of a particular legal viewpoint.

At the same time, as guardian of the Fund's legal system, however, the lawyer has a comparative advantage in several respects. First, it is acknowledged by all that the Fund is a "rule-based" organization and that it benefits from a substantial framework within which "discretionary" decisions are regularly required. In general, therefore, the search is for the governing rule and its proper application. To fortify this culture, the Managing Director and Executive Directors are often graduates from national bureaucracies and, therefore, well versed in rule-oriented systems. Second, the lawyer brings a strong portfolio of skills and knowledge—his whole training and experience are directed to the development of legal skills: the recourse to concepts ("uniformity of treatment," "set off"); familiarization with legal doctrines, principles, and practices (for example, the Vienna Convention on the Law of Treaties[15] and the meaning of immunity from judicial process); and intimate awareness of the Fund's

jurisprudence, with an acquaintance of past precedents and opinions. Finally, a legal contribution involves methodical preparation, structured presentation, and a recognition of systemic consequences.

A further important feature of the Fund's decision making deserves mention, namely, the limited prospect for review of a legal opinion or an Executive Board decision. Under the Articles, a specified mechanism for review is in place, in particular, an interpretation of the Articles under Article XXIX. However, such recourse to a "formal" interpretation—with the prospect of appeal to the Board of Governors assisted by a Committee on Interpretation—has fallen from use. Meanwhile, the Agreement between the UN and the Fund provides for a request to the International Court of Justice for an advisory opinion.[16] No such request has ever been made. In this situation, therefore, it is tempting to conclude that legal advice, to the extent at least that is accepted in practice and, as necessary, endorsed by the Executive Board, whether explicitly or in practice, assumes an adjudicatory function. This role is reinforced by the absence of any general dispute-settlement mechanism for disputes among members (in comparison to, for example, the WTO).

This, then, is the environment of a lawyer in the Fund. Perhaps it is not so far removed from a lawyer's role in other institutions—for instance, as a government legal adviser or as a company lawyer. However, even though the methods and skills are similar, there are differences—not the least of which is that lawyers in an international organization are primarily dealing with its member states and are caught up in the historic shift of authority from exclusive national authority ("sovereignty") to that of cooperative international authority.

Chapter

2 The World Bank in the Nineties

IBRAHIM F.I. SHIHATA[1]

Tempora mutantur, et nos mutamur in illis. "Times change and we change with them" is not a new adage. More global changes have probably taken place in the last few years than at any time since World War II. The scourges of that war led visionary men and women to envisage a new world of peace and prosperity underpinned by the United Nations and its specialized agencies, including the Bretton Woods institutions. By contrast, most of the world's recent transformations seem to have occurred by way of reaction, rather than by the deliberate design of great visionaries. They also aspire, however, to establish a new world order of peace and prosperity.

The World Bank and the affiliated institutions it helped create[2] have played an important, although at times controversial, role in leading economic development in the changing world of the last 50 years. This group of institutions (the World Bank Group) has yet to play an even greater role, and certainly one that will not be free from controversy either, if shared prosperity among all nations is to become the primary global goal, that is, if worldwide development that does not harm the environment is to be broadly recognized as the first challenge presently facing the world community.

Such a challenge would have required the establishment of a world institution with the capacity to harness financial resources and accumulate developmental knowledge and experience, if no such institution already existed. The World Bank has already supported over 6,600 operations in 140 countries with more than $360 billion and has become the largest center of research on development economics. Notwithstanding any shortcomings it may have, the World Bank is clearly the most qualified institution to meet this global challenge.

Recent changes in the World Bank have been pervasive, notably those covering its membership, operations, internal structure, and even its own culture.

Membership

The Articles of Agreement of the International Bank for Reconstruction and Development (IBRD) were originally open for signature on behalf of 45 countries. These included the then four independent countries in the

continent of Africa (Egypt, Ethiopia, Liberia, and South Africa), and five countries in Asia (China, India, Iran, Iraq, and the Philippines). The rest were countries in Europe and the Western Hemisphere.

The IBRD began its operations in mid-1946 with 38 member countries, including only 9 countries from Africa and Asia. At its inception, the IBRD was thus mainly a "Western" institution, both in its membership and geographic orientation. Its early loans went exclusively to European countries and its senior staff were nationals of Western countries. Today, the IBRD's membership includes 180 countries, the majority of which are located outside of the West. Since mid-1991, membership has increased by 23 countries, including one that is a major source of Bank borrowing (Switzerland) and one that is a major recipient of Bank loans (Russia).

This expansion has affected the membership of the Bank's Board of Executive Directors, increasing it to 24 members (from 22 members in 1991 and from 12 members at the Bank's inception) and changing the composition of several constituencies represented in this Board. It has also affected the Bank's operations, causing it to address for the first time the challenges of extreme and rapid transition to an open market economy by countries long entrenched in centralized systems that kept ownership of all significant means of production under strict state control.

Practically all independent countries are now members of the Bank, with the notable exceptions of Cuba, Democratic People's Republic of Korea, and the Federal Republic of Yugoslavia (Serbia/Montenegro). This globalization of Bank membership is, in fact, a reflection of major changes in the political and economic conditions in many parts of the world: the disintegration of the Soviet Union and the Yugoslav Federation, the end of the Cold War, and indeed the increasing globalization of the world economy.

The increase in Bank membership, which has also been broadly reflected in the membership of its affiliated institutions, coupled with adverse changes in the economies of some existing members, have increased the number of the operationally "IDA-eligible" members. These are the member countries eligible to borrow from the International Development Association, the Bank's concessional affiliate, because they meet certain requirements, including having a defined low annual per capita income ($905 or less in 1995 dollars is the operational cutoff figure at present, except for a few island economies in Central America and the Pacific). While these members totaled 53 countries in mid-1985, at present, IDA-eligible countries include 80 members (71 under the cutoff figure), of which 8 are east European and central Asian countries, that joined IDA after 1985.

Eligibility to borrow from the IBRD under its so-called graduation policy, has also been affected, with the graduation of six countries (Oman (1987), Bahamas (1989), Portugal (1989), Cyprus (1992), Barbados (1993), and Korea (1994)) since the formal adoption of the graduation policy in 1982. This policy, it should be noted, requires the Bank to review the eligibility of a country to borrow from the IBRD when its per capita income reaches a certain level ($5,295 in 1995 dollars), with a view to determining a phasing-out period for Bank lending, after which the country "graduates" from Bank borrowing.

Operations

The growth of Bank membership to encompass almost all countries is broadly explained by the simultaneous widening and intensification of international linkages in trade and finance. Such "globalization," as the phenomenon came to be called, has been driven, according to a recent World Bank study, "by a near-universal push toward trade and capital market liberalization, increasing internationalization of corporate production and distribution strategies, and technological change that is fast eroding barriers to the international tradability of goods and services and the mobility of capital."[3] Liberalization of trade in goods and services has now been sanctioned by the Uruguay Round trade agreements reached in 1994[4] and the establishment of the World Trade Organization in early 1995.[5]

Improved economic policies and performance in many developing countries, often guided by World Bank adjustment operations, are among the major reasons for the simultaneous, sharp increase in private flows to these countries, especially the flows that do not create debt. The latter flows account for two-thirds of all private flows, which themselves account at present for over 70 percent of all long-term flows to developing countries.[6] Among private flows, foreign direct investment now accounts for more than 50 percent.[7] Estimated net flows of private capital in 1995 reached $167 billion, representing an increase of 5.2 percent over 1994.[8] This increase may be compared with the increase of 3 percent in 1994 (over 1993) and with the much higher increases of 54 percent in 1993 and 63 percent in 1992.[9]

While the indebtedness of severely indebted countries remained large, various processes of debt restructuring and forgiveness, supported in many instances by loans from the Bank or grants from IDA, have also eased the debt burden on most of these countries. Simultaneously, the grave imbalances that characterized the economies of most developing countries at the beginning of the 1980s have been largely corrected,

often through IMF Stand-by and other agreements and Bank adjustment loans. The latter accounted on average for 36 percent of World Bank commitments and 27 percent of its disbursement in fiscal year 1990.[10] Adjustment operations have peaked, however, in many countries, and their size has started to decline. By fiscal year 1995, adjustment operations constituted 24 percent of commitments and 22 percent of disbursements.[11] Investment operations, which are the core business of the Bank, accounted for 92.5 percent of the total number of operations and 87.2 percent of total commitments in the Bank's portfolio at the end of fiscal year 1995.[12]

International consciousness of the dangers to the world environment, raised by the efforts of many governments, the UN system, and thousands of nongovernmental organizations across the world, has made the protection of the environment a major concern for all countries, not just the industrial, developed ones.

Finally, the worldwide movement towards liberalization and openness has not been limited to trade and finance. It has covered the flow of human skills, knowledge, techniques, training, and other elements of "human capital." Subsequently, it has started to reach the essence of political regimes.

These developments combined have greatly influenced the types, scope, and modes of operations of the World Bank.

Private Sector Development

Placing greater emphasis on private sector development and reliance on market forces has probably been the most noticeable development in the Bank's operations since the initiation of adjustment lending in 1980. This development has taken many forms. First, adjustment lending, which initially concentrated on macroeconomic reforms, was enlarged to include promotion of free trade, privatization of public sector enterprises, development of financial systems, liberalization of investment regimes, legal and regulatory reform, and even judicial and civil service reform. Second, these same purposes were supported by sectoral investment loans when the conditions of adjustment lending were lacking and a well-defined reform program could be agreed upon. Third, the Bank explicitly used its policy dialogue and newly adopted "country assistance strategies" to influence the developing countries' shift to reliance on market forces, often using the volume of lending as an incentive. Fourth, the Bank, after experimenting with some guarantees of private loans for investment projects under the so-called Cofinancing Program of the early 1980s and the Extended Cofinancing Program of the late 1980s, adopted in 1994 a

broad policy for "mainstreaming" its guarantee operations and started to experiment with a variety of financial instruments aimed at financing or facilitating the private financing of private investments.

In fact, Bank economists have long favored reliance on the private sector, some even arguing that the state should not do, or should not be supported by the Bank to do, anything that the market can do. The IBRD Articles of Agreement envisaged the Bank primarily as a guarantor of (or a participant in) private loans for productive purposes and a promoter of foreign private investment,[13] that would provide direct loans only when the borrower cannot otherwise obtain financing on reasonable conditions.[14] A number of factors led the IBRD to behave differently in the past, however. It cannot, under its Articles, lend directly to private enterprises without the guarantee of the state in whose territory the project is located.[15] Governments were not readily willing to provide such guarantees. They thought it more beneficial to borrow directly from the Bank for their own projects and for state-owned enterprises, which proliferated under import-substitution plans in many developing countries. Direct lending to governments and publicly owned enterprises was also a more convenient, less time-consuming vehicle for a greatly expanding Bank in the 1960s and 1970s. Furthermore, failure of public enterprises was not apparent to the Bank and certainly not to its borrowing members.

An affiliated organization, the International Finance Corporation (IFC), was created early in 1956 to provide financing to the private sector without government guarantees and, after a long hesitation, another affiliate, the Multilateral Investment Guarantee Agency (MIGA), was established in 1988 to encourage foreign investment mainly by providing guarantees against noncommercial risks.[16] Through these affiliates, the World Bank Group was seen by its members as paying adequate attention to the private sector.

Enthusiasm for the "magic of the market place" under the Reagan administration in the United States and the Thatcher government in the United Kingdom certainly influenced the thinking of many other governments. A review of the capital adequacy of the IFC in 1989 prompted broader thinking on the role of the World Bank Group, including the IBRD and IDA, with respect to private sector development. The collapse of the Soviet system and of the Council for Mutual Economic Assistance erased lingering doubts in the minds of some Bank members concerning the need to emphasize further private sector development in the Bank's operations. The shift toward creating an enabling environment for the private sector and promoting its financing through private channels became prevalent in the Bank's work. Privatization came to the forefront in the policies of the Bank and its members both as a means to ensure enterprise

efficiency and to create fiscal space for governments with large deficits caused by public sector losses. In the late 1980s and early 1990s, the Bank was perceived at times by some critics as holding extreme views against the role of the state in the economic field. A balanced approach was described clearly in the 1991 *World Development Report*[17] and finds its most recent expression in the following statement in the Bank's report to the 1995 UN Conference on Social Development (the Social Summit):

> Governments can contribute to economic and social progress by focusing on the things that they do best. At one extreme are public goods—law and order, national security, and an environment conducive to business—which only a government can provide. At the other extreme are sectors in which private producers are active and efficient, but where selective government intervention is sometimes needed to correct for market imperfections or failures. In other areas there is need for a judicious mix of government and private involvement—in health, education, physical infrastructure, agricultural research and extension, and protecting the weak and vulnerable members of society. What really matters is how effective and efficient a government is in discharging its responsibilities. And because administrative capacity is often weak in developing countries, governments need to choose the areas of intervention carefully and give priority to institution building.[18]

Not only moderation is called for in this critical matter, differentiation by country is equally important. Private external financing is still concentrated on a few, although slowly expanding, number of countries (about 75 percent of it went to 12 countries in 1995).[19] The local private sector is still too weak in many countries to allow for large-scale privatization programs or significant locally based private initiatives. Even in the few countries that receive large amounts of foreign private investments, the private investments are likely to be concentrated on a few sectors and rarely finance social development. Short-term flows are fragile and subject to setbacks, as evidenced by the peso crisis in Mexico in late 1994 and early 1995. External shocks, domestic policy reversals, or even the perception that these may be forthcoming could cause capital flight at a higher speed than that at which the capital flowed in. Under these circumstances, the Bank's unequivocal support of the private sector, both local and foreign, should not lead it, in the view of this author, to take an absolute position against any Bank financing for those efficiently run public enterprises that cannot otherwise receive long-term financing on reasonable terms. This view is in line with the purposes of the Bank as spelled out in its Articles of Agreement.[20]

Social Development

Concern for social development is not new to the Bank. Financing of social projects was pioneered by it in the early 1960s. Such financing has, however, received a much stronger emphasis in recent years. The macro-

economic reforms undertaken by many developing countries in the 1980s required drastic budget cuts that many governments found more convenient to apply to expenditures on social services. This caused a world outcry for "adjustment with a human face." The creation within the Bank of a vice presidency for human resources development in 1992 provided the institutional backing and the technical base for a people-oriented approach to development.

A dramatic increase in "investment in people" coincided with the universal call, championed by the Clinton administration in the United States, to put "people first" and received broad support from the Bank's membership. While Bank lending (that of the IBRD and IDA) for this purpose represented some 5 percent of total lending in the early 1980s, it reached about 17 percent in 1994 and 15 percent in 1995, with greater emphasis on primary education, girls' education, and primary health care.[21] The Bank's annual lending has now exceeded $2 billion for education, $1 billion for health, and $200 million for family planning and other population activities.[22] Its lending in support of the provision of social safety nets through adjustment and investment loans has also reached substantial figures.[23] Lending for this purpose alone reached $2 billion in 1995.[24] The Bank's present plans include increasing lending for human resource development to $15 billion from 1996 to 1999.[25] Emphasis on this area also led the Bank to building stronger ties with various nongovernmental organizations in both developed and developing countries that now participate in the design, preparation, appraisal, financing, implementation, and supervision of many Bank-supported projects.[26] More recently, mainly through the initiative of the Bank's vice presidency for environmentally sustainable development (also created in 1992), the Bank succeeded in establishing a new umbrella facility for the grant financing of microenterprises.

Equally important has been the Bank's new practice of reviewing public expenditures with borrowing governments in the course of its policy dialogue with them and during the preparation of its "country assistance strategies." Such reviews typically aim at ensuring that adequate funds are being allocated for social services and that such services are being provided efficiently and equitably.

The Bank's new emphasis on "participatory development" is also a recent but fast-growing phenomenon. The purpose of this approach is not only to incorporate grassroots experience in the design and implementation of projects, but also to keep abreast with the worldwide trend toward the increased empowerment of people and the rise of civil society. Influential voices within and outside the Bank are now calling for a rapid expansion of such a participatory approach, with some suggesting that "the Bank's clients are not the governments to which it lends, but the poor it is seeking to help."[27]

Governance

The Bank's concern with governance issues in its borrowing countries was formally reflected in its policies in the early 1990s,[28] following a major Bank publication on the malaise of sub-Saharan Africa in 1989[29] and a legal memorandum on the subject by this author in 1990.[30] Governance issues have since become a major concern in the Bank's relationship with many borrowing countries, especially those in sub-Saharan Africa. Lending for the improvement of countries' governance (to promote the overall efficient management of their resources) has supported legal, judicial, and civil service reform, under both adjustment and investment loans, including the introduction of measures to enhance public accountability and greater transparency in government actions.

The Bank is now called on by certain nongovernmental organizations, politicians, and academics to expand further its governance work not only geographically but also in the scope of the issues it covers. In particular, the Bank is asked to involve itself in the political reform, that is, in the democratization efforts of its borrowing members. The promotion of political human rights through Bank operations is frequently mentioned in this respect. This, however, raises serious questions with respect to the Bank's specialized mandate and to explicit provisions in its Articles of Agreement that prohibit it from interfering in the political affairs of its members and from taking into account any consideration that is not economic in character.[31] This matter, which is likely to remain an issue of concern, ought not to be contentious, however. Without violating its Articles of Agreement, the Bank is promoting liberalization and the opening of economies; helping education for all; and assisting governments in reforming their legal, judicial, and administrative systems. Progress in these three areas creates an environment for political reform from within, which is likely to be much more sustainable than any political reform imposed or induced from the outside. There is also ample evidence that progress in these areas, especially the opening of the economy and the establishment of the rule of law and of an independent judiciary, leads to the evolution of more democratic forms of government.

Environment

The Bank's concern for the conservation and protection of the environment is not new.[32] What is new is the enormous expansion of the Bank's work on the environment and the integration of this work in the Bank's operations, as well as the establishment in 1991 and the restructuring in 1994 of the Global Environment Facility (GEF), of which the Bank is the main implementing agency and the trustee of its funds.[33] New policies have been adopted by the Bank in recent years concerning lend-

ing for forestry, energy, agriculture, and water resources and emphasizing participation in the projects it finances. Policies regarding environmental assessment, dam and reservoir projects, involuntary resettlement, indigenous peoples, and pest management were incorporated in the Bank management's instructions to staff, previously called "Operational Manual Statements" or "Operational Directives," which have been or are being redrafted in a new format of "Operational Policy" statements. In all these policies, the Bank has been trying to achieve sound, some would say idealistic, standards for the protection of the environment. In addition to addressing environmental concerns in every project financed by the Bank where such concerns are likely to arise, the Bank's lending to primarily environmental projects has reached $9 billion over the past decade,[34] not including the financing of environmental projects by the GEF and other Bank-administered trust funds. Ongoing research, meanwhile, continues in the Bank on how to factor depletion of natural resources in the costing of projects and, more generally, in national accounts. This is an area of enormous potential impact on the Bank's work and on economic development in general.

Debt

As already noted, the crisis dimensions of developing countries' indebtedness have subsided somewhat, thanks to the Paris Club's restructuring and relief efforts and the commercial banks' debt restructuring agreements supported by both the International Monetary Fund and the World Bank. However, some of the poorest developing countries remain heavily indebted. The overall external debt of developing countries, although now easier to service for most of them, has in fact increased, reaching an estimated $1.9 trillion in 1994 and over $2 trillion in 1995.[35] The plight of the heavily indebted poor countries, whose debt is mainly owed to official sources, is at present a source of particular concern. The debt of 8 such countries has been considered "unsustainable" in recent Bank-Fund staff studies, while 12 other such countries are deemed to be "possibly stressed" and 3 countries' debt was "not yet determined." For the "unsustainable" and "possibly stressed" heavily indebted poor countries, 55 percent of the total debt of $122 billion (nominal value) in April 1996 is official bilateral, 29 percent is official multilateral, 11 percent is private, and 5 percent is short term. Of the multilateral debt, 42 percent is owed to IDA, 9 percent to the IBRD, 15 percent to the IMF, 8 percent to the African Development Fund, 7 percent to the African Development Bank, and 19 percent to others. The Paris Club debt represents 61 percent of bilateral debt.

The Paris Club announced in 1994 new terms for the reduction, on a case-by-case basis, of official debt of "the poorest and most indebted

countries"—the so-called Naples Terms—under which a 67 percent present value reduction in eligible debt or debt service may be given to countries with a per capita income of $500 or less or a debt-to-export ratio of 350 percent or more, and a 50 percent reduction may be accorded to the remaining eligible countries.[36] The share of indebtedness to multilateral institutions in the total debt of the poorest countries has consistently increased in recent years and stood at $34 billion at year-end 1993.[37] The debt-service payments on multilateral debt of the heavily indebted poor countries have in fact risen to $4.8 billion in 1995 from $1.9 billion in 1984.[38] This is a direct result of increased lending by multilateral institutions, especially IDA, to these countries in the face of stagnating bilateral official flows and the virtual disappearance of commercial lending. Nevertheless, net transfers continue to flow from sources such as IDA to these countries.

Because the debt burden is particularly heavy on these vulnerable countries, many calls were made from both official[39] as well as nongovernmental[40] sources for the forgiveness or reduction of multilateral debt. In early 1996, the Bank and the IMF managements prepared a proposal to tackle the debt problem of the heavily indebted poor countries in a comprehensive way, which requires close cooperation with, and further financing by, bilateral creditors and other multilateral development banks. Assistance under this proposal would be confined to a limited number of countries that establish a track record of reform and the debt of which is nonetheless deemed to be unsustainable. It calls for debt forgiveness by the Paris Club bilateral creditors (up to 90 percent of present value of the debt) and for servicing multilateral debt through a new multilateral trust fund to be financed by bilateral donors and multilateral development banks and administered by IDA. The proposal has been endorsed in principle by the Development Committee in its spring 1996 session, and its details were subject to further refinement for submission to the Development Committee and the Board of Governors during the Annual Meetings in October 1996.

New Lending Instruments and Business Practices

The reorganization of the Bank introduced in 1992 by its late President, Lewis Preston, and the "vision paper" resulting from its fiftieth anniversary review,[41] completed in mid-1994, emphasized flexibility, selectivity, innovation, client orientation, cost-effectiveness, and results orientation. These goals have been, and are being, reflected in recent Bank operations, as witnessed by a number of novel approaches.

The Bank has initiated "rehabilitation" and "economic recovery" loans for countries, such as Russia, whose conditions did not enable them to

receive full-fledged adjustment loans. The Bank also created new development lending instruments, such as "emergency loans," to help governments cope with the needs caused by natural disasters and similar emergencies. Furthermore, it provided 46 "contingent loans" for countries that preferred this form of stand-by credit enhancement over a Bank guarantee. It converted its special Extended Cofinancing Program into a general program for bank guarantees of private loans. In response to possible borrowers' preferences to borrow in a single currency (rather than in the pool of currencies in which the Bank borrows), the Bank has also adopted, first as a pilot program then on a general basis, an optional system of single-currency lending, which is being expanded at present.

In the meantime, a new approach to the overall processes of Bank lending has been tried by a number of the Bank's country departments. This business practice innovation exercise involves, in particular, the streamlining and simplifying of the lending process by measures such as reducing the number of required approvals within the Bank; changing the focus and content of the process of financing projects (for example, by cutting down the phases of the project cycle and authorizing negotiation of loan agreements in the field); altering the format of the process; and involving borrowing countries in the preparation of the country assistance strategies. To achieve such results, the new procedures allow a greater measure of delegation and rely more heavily on the Bank's field offices in the appraisal and supervision of projects.

The Bank's Internal Structure and Culture

Throughout its history, the Bank has introduced a number of reorganization schemes to allow its internal structure to respond more effectively to the changing needs of its clients and to provide a more suitable "skills mix" for this purpose within its staff. A major reorganization introduced in the 1970s by Robert McNamara (the Bank's President from 1968 to mid-1981) served the Bank well, until a new major reorganization was introduced in 1987 by Barber Conable (the Bank's President from mid-1986 to September 1, 1991). The most prominent features of the latter reorganization, which resulted in the laying off of over 500 staff members, introduced a clear country focus in Bank operations through country departments within each operational region, which combined the previous project departments and program departments. While this country focus remains a hallmark of Bank operations, a number of successive organizational changes were later introduced by Lewis Preston (the Bank's President from September 1991 to May 1995). These changes included the replacement of the three senior vice presidents (for operations, finance, and policy and economic research, respectively) by three

Managing Directors, each having varied responsibilities that combined operational and nonoperational activities, and who, with the President, constituted the President's Office. The changes also included the restructuring of the six regional vice presidencies in terms of the countries included within each region. This was followed by the establishment of three central, thematic vice presidencies to strengthen the Bank's technical base in certain areas of special emphasis (in addition to the technical departments within the regions under the existing organization). They cover Human Resoures and Operational Policy, Environmentally Sustainable Development, and Finance and Private Sector Development.

Effective January 1, 1996, James D. Wolfensohn, the Bank's President as of June 1, 1995, has restructured the top management of the Bank to provide clear lines of authority for the main areas of Bank business and to strengthen the World Bank Group's ability to address major strategic issues and follow up on their implementation. One key purpose of the new top management structure is "to provide a framework for liberating the energies and skills of the organization." To that end, top management has been regrouped and the positions of Managing Directors who report directly to the President have been restructured. Two Managing Directors are jointly responsible for the Bank's operations and operational policies, with distribution of responsibilities among them being based on geographic and functional bases. Another Managing Director is responsible for human and information resources and management services for the Bank Group, as well as for corporate planning and budgeting for the Bank. A fourth Managing Director is responsible for finance and resource mobilization. A fifth Managing Director is in charge of coordination between the strategies and policies of the different World Bank Group institutions in the area of private sector development. Each of the two Managing Directors in charge of Operations has line authority over a number of regional and central vice presidencies. The Managing Director, Human and Information Resources, Management Services, Corporate Planning and Budgeting, has authority over the two new vice presidencies, one for human resources and the other for information systems, as well as over the Director, Facilities and General Services, and the Director, Planning and Budgeting. The Managing Director, Finance and Resource Mobilization, supervises the functions of four vice presidencies: Treasurer's, Controller's, Financial Policy and Institutional Strategy, and Resource Mobilization and Cofinancing. The fifth Managing Director, responsible for the coordination of Private Sector Development activities, works with the senior managers of the Bank, the IFC, and MIGA to develop the World Bank Group's overall strategy for private sector development and to ensure concerted actions and effective cooperation among the World Bank Group's institutions in the promotion of private sector development.

The main purpose of the organizational changes is to transform the Bank into a more result-oriented institution. This new focus on outcomes, rather than processes, has led to a number of immediate steps, including in particular the refocusing on quality control and the streamlining of internal processes. The Operations Committee now reviews country assistance strategies and selected operations that warrant Bank-wide attention because of their policy implications, risks, and innovative nature. The Operational Policy Committee, which previously reviewed the output of central vice presidencies, now plays a more active role in defining the Bank's operational policy agenda, resolving issues of policy design and implementation, and formulating revised and new policies for approval by the Board. As a result of its work, clear, consistent, and coherent policies are expected to provide more scope to delegate decisions, empower staff to deliver high-quality work, and hold staff and managers accountable for results.

Under the new structure, Mr. Wolfensohn has also established a new Executive Committee that meets weekly, consisting of the five Managing Directors; the Senior Vice President and General Counsel; the Senior Vice President, Development Economics and Chief Economist; the Vice President and Chief of Staff; the Vice President and Secretary; and the Vice President, External Relations. This Committee is enlarged to include the Executive Vice Presidents of the IFC and MIGA whenever matters related to the management of the World Bank Group as a whole are involved.

Two major changes were also introduced in 1993 for the purpose of increasing transparency in the Bank's work and strengthening its system of accountability. The first was the adoption of a more open disclosure policy, which resulted in the creation of a Public Information Center and which authorized public access to a host of Bank documents previously considered confidential.[42] The second change was the adoption by the Bank's Board of Executive Directors of a resolution establishing an Inspection Panel to review complaints concerning the Bank's noncompliance with its policies and procedures with respect to the design, appraisal, and implementation of projects.[43] This panel was actually constituted in April 1994 and has since had four requests for investigation. One has led to a full investigation (the Arun III Project in Nepal) and another to a major action plan to accelerate project implementation (the Rondonia Project in Brazil).

Both of these innovations followed the issuance in 1992 of a report by a task force consisting of Bank staff to review the Bank's portfolio of loans.[44] This task force, which was chaired by an experienced Vice President, Willi Wapenhans, undertook, in fact, a broad review of the

Bank's practices and procedures and produced the "Wapenhans Report," a major critique of the Bank's work that included extensive suggestions for improvements. The recommendations of the Wapenhans Report led the Bank's Management to prepare a detailed program of "next steps," which, having been sanctioned by the Bank's Board, is now under active implementation.[45]

One of the major findings of the Wapenhans Report was that the Bank suffered from an "approval culture" where achievement was measured more by the approval of new loans rather than by the successful implementation of the projects for which the loans were made. The report called for the replacement of this culture by an "implementation culture," which further stresses the Bank's supervision of project implementation and the need for flexibility in changing project design and loan amounts as may be needed for the successful completion of each project.[46]

A more recent task force, established by the Development Committee in 1994 to carry out an overall review of the activities of multilateral development banks, completed its report in March 1996.[47] Unlike the earlier task force, this one consisted of deputies of the Development Committee members selected by these members and was chaired by an experienced outsider with over 30 years of experience in dealing with the Bank.[48] Mr. Wapenhans served as the head of the Secretariat of this task force. Their report, which was considered at the ministerial level in the Development Committee in April 1996, validated many of the existing and emerging practices of the World Bank Group and has also called for placing greater emphasis on client orientation and project implementation. In particular, the report called on multilateral development banks to further coordinate their activities at the country level, the multilateral development bank level, and among the multilateral development banks as a group.[49] It asked the multilateral development banks to continue to mobilize international private savings and concessional assistance and to be selective in their use of B-loan syndications with commercial creditors (where the multilateral development bank remains the lender of record). It also recommended that alternative methods to loan guarantees (such as wider multilateral insurance coverage of private investors) be considered. Finally, the report restated many of the new emphases in the Bank's operational policies. Its call for "upgrading the roles of the Executive Boards" restated points that, for the most part, had been adopted in the Bank's Board.[50]

Earlier reviews by Board committees (consisting of Bank Executive Directors) resulted in major changes in the manner in which the Bank operates. An Ad Hoc Committee on Board Procedures suggested, among other things, in its 1992 report (known as the Naim Report)[51] that man-

agement submit for Board consideration periodic reports on its "country assistance strategy" for each borrowing country. Such reports discuss the development efforts and needs of the country in the medium term and the Bank's expected role (including its lending program for the country). Such broad country discussions were found controversial in the past and were resisted by a number of Bank borrowers that, for good measure, suspected that the discussion would focus on the overall countries' strategies, not only on the strategy of the Bank's assistance to them. They were eventually accepted, however, as a mechanism to rationalize Bank operations and allowed the Board to approve projects consistent with a country's Country Assistance Strategy under a streamlined procedure that normally disposed of the need to discuss the projects in the Board except for unusual and large loans. The process of country assistance strategy preparation has since evolved in a manner requiring active consultation with the country concerned and its civil society. New country assistance strategies also seek to integrate the full array of services provided by the World Bank Group and link allocations to the country to monitorable targets. The fears that preceded the adoption of this process have meanwhile been put to rest.

Another Board committee, the Ad Hoc Committee on Board Committees, suggested in 1994, in what came to be known as the Maelhum Report,[52] a number of changes aimed at strengthening the role of the Board of Executive Directors and further ensuring appropriate project implementation and evaluation. As a result, a new standing Board Committee on Development Effectiveness was established to focus on the review of the work of the Bank's Project Evaluation Department and to recommend to the Board further policy changes. A strengthened Budget Issues Committee also replaced the Board Committee on Business Practices and Budget Effectiveness, which had been established in 1989 after much debate.

The combination of the above-noted changes, coupled with previous criticism of the Bank by outside sources and, more important, the driving spirit of its new President, is having its impact on the Bank's culture. The emerging culture is one that stresses client orientation, causing the Bank to act as a bank should. It places particular emphasis on project implementation and the supervision by the Bank thereof. It increasingly requires participation by affected stakeholders in all phases of the project cycle. It tries to streamline this cycle and reduce the time needed for its completion. In furthering these goals, the emerging culture allows a greater measure of openness and disclosure of information, and increased reliance on the work of the Bank's field offices and on the cooperation of nongovernmental organizations.

Future Directions

In spite of the magnitude and pace of changes in the Bank's work, pressure continues from various sources aiming at introducing further, and sometimes conflicting, changes. Developed member countries would like to increase the Bank's effectiveness and reduce its cost. Some of these countries may also be tempted to use the Bank as an instrument to achieve their foreign policy goals. Borrowing member countries, while appreciating the need for greater effectiveness and lesser costs, would like the Bank to increase its lending, reduce its conditionality, and be more responsive to the special circumstances of each country. They strongly resist politicization of the Bank's work or its use as an instrument of foreign policy of donor countries. They take a steadfast position against the Bank's intrusion in their domestic political affairs but want the Bank to be more appreciative of the political difficulties facing governments that implement Bank-supported adjustment programs. Nongovernmental organizations concerned with the Bank's work have different goals. Some would like to assist the Bank in carrying out its stated purposes, thus increasing its efficiency and productivity. Some would like the Bank to pay much greater attention to social development and the environment, accepting the almost inevitable result of having a slower and perhaps smaller Bank. Some wish the Bank to become an instrument of democratization and political reform in its borrowing members, even if this means its deep entanglement in the domestic political affairs of these countries. Others seek nothing less than the closure of the Bank.

While trying to respond to outside demands, the Bank is becoming a less dominant source of development finance (except for IDA-only countries). Its share in the aggregate long-term net resource flows to developing countries is estimated to have declined to only 2.6 percent in 1995.[53] Its importance to countries that are large recipients of private finance has certainly declined, at least to the extent that the flow of private funds has been steady and stable. Its competition with other regional and bilateral sources of development finance is also being felt, at least in some countries. The Bank's growing reluctance to finance public sector enterprises in an increasing number of borrowing countries is also reducing its opportunities for lending. The Bank's insistence on addressing broad policy issues and introducing policy conditions in most of its loans is making the Bank truly a lender of last resort for some countries. This is increasingly evident in countries that could otherwise obtain financing without, or with less burdensome, conditions.

As previously explained, the Bank is devising ways to expand its support of external private lending to developing countries through guarantees and other credit enhancement mechanisms. It has also studied whether it

would be useful to amend the IBRD Articles of Agreement to dispose of the need to obtain a government guarantee when it lends to a borrower other than the government. An internal study undertaken in 1990 by a World Bank Group task force, chaired by this author, concluded that such nonguaranteed lending, if unchecked, would raise a host of serious policy, operational, financial, and legal issues and should therefore, if considered, be limited to a small fraction of the Bank's loan portfolio. The Bank's management has since considered alternative means of expanding the World Bank Group's financing of private sector enterprises, including raising the operational gearing ratio for IFC borrowing (to enable it to harness greater resources for its operations that are free from the government guarantee requirement); "mainstreaming" guarantees in the Bank's own operations; and expanding MIGA's political risk insurance capacity.

The Bank's efforts to coordinate its activities and lending strategies with other sources of official development finance may also be enhanced with a view to maximizing the benefit to recipient countries. In this context, the Bank has been joining regional development banks, other development finance institutions, and bilateral donors in the financing of many operations and has played a leading role in "aid coordination" for a growing number of countries. More recently, it has shown a readiness to accept a leadership role with regional banks in the smaller countries where the Bank's lending program is smaller than that of the regional bank involved. At the initiative of the Bank's new President, the heads of the multilateral development banks now hold periodic meetings to ensure closer cooperation and synergy in their activities while allowing for a measure of "constructive competition." Periodic meetings among multilateral development banks on functional issues (operations evaluation, legal, and so on) are also being conducted at the department head level.

The Bank will continue to strive for further efficiency gains. The six "guiding principles" adopted in 1994 required the Bank to

- increase the selectivity of its activities with a view to moving out of activities that others are better placed to perform;
- strengthen its partnership in the international development community, particularly at the country level;
- emphasize client orientation by being more responsive to the needs and circumstances of each borrowing country;
- increase results orientation by placing greater emphasis on project implementation and achieving better results "on the ground";
- ensure cost-effectiveness through further efforts to contain costs, streamline procedures, and improve coordination; and

- maintain a strong commitment to financial integrity by continuing the prudent financial management that helped the Bank to maintain the highest credit rating in financial markets.[54]

These are all rational and sensible principles for any organization to follow. Following them to their logical conclusions may in the long term lead the Bank to consider whether having four financial institutions in its Group represents an optimal arrangement at a time when all these organizations seem to give the same priority to private sector development. Under the stewardship of its new President, the institutions of the World Bank Group are now called on to better coordinate their activities and to work closely together to serve their common objective, while preserving their legally separate structures and decision-making processes. As already mentioned, a high-level mechanism has already been established for this purpose, the Private Sector Development Group, chaired by a Managing Director. The question may arise in the future whether the merger of the IFC and MIGA in the IBRD and the restructuring of IDA as a large trust fund of the new IBRD represent a more efficient and cost-effective solution. This is not, however, an idea that has been considered, or even envisaged, in the different exercises of reviewing the World Bank Group's work.[55] Only the merger of the World Bank and the IMF has occasionally been mentioned by some outside observers without a serious follow-up.[56]

Whether in their present forms or in the form of an amalgamated megainstitution, the institutions of the World Bank Group will have to face the challenge of helping the world community, and developing countries in particular, in the new world of open markets, increased private flows, and possibly decreased external concessional flows (foreign aid). The opening up of markets and the free convertibility of currencies on the one hand and new telecommunications technologies on the other hand have made trading in different national securities and currencies increasingly immune to geographic and time zone limitations. A virtually global market now operates on a 24-hour basis. This market is a private one that depends entirely on the confidence of the participants. It is vulnerable to shocks whenever this confidence is threatened for real or perceived reasons. It is also a market that is beyond the capacity of any individual government to regulate. Yet, its stability, competition, and ability to respond quickly to failures may call for a new framework of rules. The flow of private funds has no comparable system to the Uruguay Round trade agreements,[57] which include an Agreement on Trade-Related Investments Measures, now under the general supervision of the World Trade Organization. The global financial market may need an internationally coordinated framework that respects and promotes the market's basic features but aims at reducing its failures. At a minimum,

such a system should ensure the flow of timely and accurate information on the dealings of the global market and the circumstances surrounding them, and should put in place an efficient system of surveillance by a central international forum such as the IMF. It is gratifying to observe that agreement has recently been reached to strengthen the IMF's surveillance role in this respect.[58]

Global markets, both for the exchange of goods and services and for the transfer of private funds, present a new set of requirements to developing countries. The "conditionality" of these markets, with their requirements of free entry and exit and open competition, may even be much harsher than that attached to multilateral loans. However, few developing countries may be prepared to meet the test of this unwritten conditionality and to quickly adapt themselves to the changing requirements. The World Bank Group may have to devise new ways to help them meet this new challenge. The Bretton Woods Commission was right to point out in its report commemorating the fiftieth anniversary of Bretton Woods that, "[o]f the challenges facing the World Bank Group, none is greater than adapting to a world that has turned from public sector dominance towards private enterprise and free markets."[59] The pace of this adaptation inevitably varies from one country to another, but the process is prevalent and growing.

Since 1983, the year in which I joined the service of the World Bank as its General Counsel, the Bank has had four Presidents. The Clausen years were characterized by adjustment lending, macroeconomic reforms, and strengthening the Bank's standing in financial markets. The Conable years, while continuing these trends, introduced the "country focus," and saw a greater emphasis on the protection of the environment as well as starting the emphasis on private sector development, cooperation with nongovernmental organizations, and governance issues. The Preston years, without neglecting any of the foregoing, witnessed major changes in the Bank's internal structure and its way of doing business, and a definite concentration on client-oriented approaches to private sector development. More than ever, it became clear that the Bank has come to face the difficult challenge of how to cater for the needs of the least-developed countries, while assisting other developing countries entering the global market in meeting the challenges and requirements of this market.

Although Mr. Wolfensohn's presidency of the Bank Group only started on June 1, 1995, his impact has already been widely felt not only in the restructuring of the Bank's top management but, perhaps more important, in the Bank's orientation and manner of doing business. Focusing on results on the ground; listening to borrowers and other stakeholders, including especially the civil society in borrowing countries; modesty in approach; and quality in the service are important messages

that characterize this new era and that should result over time in profound changes in the Bank's culture.

The World Bank is entering a new phase of its history in an external environment characterized by dwindling support of, if not disaffection with, multilateralism in general and development assistance in particular, coupled with criticism of the Bank, which was led by vocal groups in many countries. The Bank's demonstrated readiness to adapt itself to the needs of a changing world, its ability to continuously improve its strategies and operational practices, and its dynamic new leadership are the factors of promise that should help the Bank meet this new challenge.

Chapter

3 Developments at the International Finance Corporation

MOTOKO AIZAWA[1]

The fortieth anniversary of the founding of the International Finance Corporation (IFC) was marked in 1996. The IFC, the second-oldest member of the World Bank Group,[2] was established to promote development in its member countries by supporting the private sector. Unlike the World Bank, which is involved mostly in multilateral lending to governments, the IFC uses market-based approaches to assist private enterprise without a guarantee of repayment by the member government concerned. Since its inception, the IFC's membership has grown to 172 countries. In 1995, the IFC welcomed Armenia, Georgia, Moldova, and Tajikistan as new members.[3] Since its inception, it has provided more than $16 billion in financing for approximately 1,600 business ventures in 114 developing countries.[4] The IFC is now the world's largest multilateral source of direct investment for private project finance in developing countries.[5]

In recent years, the IFC witnessed a global trend toward greater encouragement of private initiative and the development of a viable private sector. The sweeping reforms in Central and Eastern Europe, the Baltic countries, Russia, and the other countries of the former Soviet Union are the most obvious example. In these regions and elsewhere, the IFC supports the transition to market economies by providing legal, financial, and technical advisory services in privatization. The IFC's funds buttress the crumbling infrastructure in many of these countries. Capital markets of developing countries and the small and medium-sized enterprises of those countries also require nurturing in order to ensure that domestic savings are channeled into long-term investment. As economies develop and mature, however, developmental agencies, their member countries, and members of the public all struggle with the issue of sustainable development and the relationship between finance and the global and local environmental impacts. These changes in the political, economic, and developmental climate have confronted the IFC with special challenges.

IFC's Role as Investor in the Private Sector

Traditionally, the IFC has been most active in project finance, acting as a project lender, investor, or both in private sector financing in cases where other private sources of funds are not available. Using its own funds, the

IFC participates in projects whose prospective earnings are likely, in the IFC's judgment, to be sufficient to meet debt service and to earn an acceptable return on equity. In other words, project finance lenders look to the expected cash flow from the project only as a source of repayment. Except for certain project completion or financial support obligations on the part of the project sponsor to ensure the project's commercial operations, there is no recourse against the project sponsors. Furthermore, unlike the World Bank itself and many other multilateral institutions, the IFC is prohibited from accepting government guarantees of its loans or equity investments. This means that the IFC always takes the commercial risk.

Although, as a rule, the enterprises financed by the IFC are wholly or majority privately owned, the IFC may provide funding for a company with minority government ownership, provided that the private sector is participating and the venture is operated on a commercial basis.

IFC's Role as a Mobilizer of Resources: The "B" Loan Program and the Capital Markets

The IFC, in connection with its project financing activities, also mobilizes resources from the private sector. Under the "B" Loan Program, the IFC lends to projects, in addition to its own funds (the "A" Loan), those funds obtained from commercial banks through the sale of participation in the IFC "B" Loan. The borrower's contractual obligation is to the IFC as the lender of record. The participating commercial banks provide their own funds and take their own commercial risk. However, participating banks receive the same treatment from the host government and the project sponsors as does the IFC, including immunity from taxation, and any default is a direct default to the IFC. No IFC loan, including portions taken by participants, has ever been included in a country's general external debt rescheduling. Because of these factors, banking regulators in a number of industrialized countries have introduced exemptions from country-risk provisioning requirements for participation in the IFC's loans.[6] These factors provide the commercial banks with the necessary comfort to enable them to participate in projects with risk profiles that they otherwise are not prepared to accept on their own.

As a mobilizer of funds, the IFC also sponsors and underwrites portfolio funds for investing in local markets, or arranges and underwrites international securities issues by companies from emerging markets. Besides being active in international markets, the IFC also uses innovative products to promote foreign portfolio investment in emerging markets.

In fiscal year 1995, for every dollar that the IFC approved for its own account, it mobilized $5.73 from other investors through the "B" Loan

program and through other pooled investment vehicles in the emerging markets.[7]

Current Developments

Privatization and Advisory Services

The dramatic political and economic changes in Central and Eastern Europe, the Baltic countries, Russia, and the other countries of the former Soviet Union have necessitated equally dramatic changes in the legal and institutional framework of those countries. These changes have increased the demand for the IFC's investment and technical and financial advisory services in these countries, particularly in the area of privatization. The IFC's aim in these former command economies is to maximize its impact in accelerating the transition to productive market economies.

The IFC actively promotes privatization as a policy instrument to promote private sector development. It offers extensive experience to government clients in the area of public sector reform and the restructuring of state-owned enterprises. During the past few years, the IFC has advised several member governments seeking to improve the managerial and competitive efficiency of state-owned enterprises through partial or complete privatization. The IFC prepared and implemented the privatization of thousands of small enterprises in Russia, as well as scores of small firms in Ukraine.[8] The IFC designed an auction method for privatization, which both countries now use as a model. Many small businesses have now been privatized in Russia using this method.

The IFC also provides transaction-specific advice on legal, technical, and financial issues that arise when state-owned enterprises undergo privatization. The IFC's assistance frequently covers postprivatization issues as well as advice on rehabilitation, modernization, expansion, and financial restructuring of projects. The IFC also assists buyers from the private sector to purchase state-owned enterprises when they are put up for sale.

One of the IFC's long-term priorities is to promote and develop domestic capital markets. As such, the IFC is active in providing advisory services to governments on fiscal, legal, and regulatory matters and on the institutional structure required to develop a market-oriented financial sector. For example, the IFC provided advice on the design and development of the general legislative environment for the establishment of a stock exchange in a number of countries.[9] Such advisory work often involves providing recommendations on the drafting or revision of a company's law and on the oversight of enforcement entities and their procedures. In the past few years, requests for assistance have increasing-

ly focused on improving market infrastructure, such as assessing options for trading, clearing, and settlement functions. Recently, the IFC helped Russia open its first independent share registry, developed at the request of the government of Russia in cooperation with the European Bank for Reconstruction and Development and the Bank of New York.[10]

In addition to advisory services conducted by the IFC's investment and specialist departments, the IFC also participates in advisory services through the Foreign Investment and Advisory Service (FIAS), a joint World Bank and IFC venture.[11] The FIAS advises governments on foreign investment laws, policies, regulations, and procedures. It also organizes the framework and institutions needed to promote and regulate foreign direct investments. In 1995, FIAS completed 26 advisory assignments in 27 countries.[12]

Infrastructure Projects

Significant changes are under way in the financing of basic infrastructure. While infrastructure projects used to be closely regulated and exclusively financed by the public sector, many governments now look for private capital for infrastructure projects instead of using their own resources. Private capital is in high demand globally for power generation and distribution projects, telecommunications systems, ports, highways, urban sanitation systems, and the like. These key businesses are increasingly subject to less regulation. Deregulation, in turn, attracts foreign direct investment.

In response to demands for private funds by IFC member countries for infrastructure projects, the IFC established the Infrastructure Department in 1992. The Department is subdivided into the Transport and Utilities Division, the Power Division, and the Telecommunications Division. In 1995, for infrastructure projects, the IFC approved financing of over $730 million for its own account and approximately $1,050 million in additional loans from commercial banks under the "B" Loan Program.[13] Infrastructure projects accounted for 25 percent of the IFC's 1995 approvals.[14] Infrastructure investments included Vietnam's first private port, which will help stimulate development in the Thi Vai River region.[15] The IFC has also invested in Bangkok's new elevated rail system in order to ease traffic congestion and pollution.[16] In Buenos Aires, in just two years, an additional 800,000 people are getting their first water and sewerage service because of the IFC's investment in Aguas Argentinas.[17]

Of the various sectors financed by the Infrastructure Department, however, the power sector experienced the most growth. Power projects frequently involve high capital costs, at times in excess of a billion dollars, and long payback periods. However, private power projects in developing

countries may find it difficult to attract foreign direct investments, particularly long-term funds. Frequently, a private power project has only one purchaser for its power, which is likely to be a utility company controlled by the host government. Owing to a subsidized tariff structure, the utility may not be creditworthy. Even in cases where the utility has already been privatized, such companies may lack credit history so that their financial performance in the future is questionable. In addition, few lenders worldwide have experience in financing private power projects because the power sector has not historically been open to private companies in the developing world. Foreign investors are particularly cautious because power projects are not export oriented and thus do not generate hard currency. Revenues are often subject to the rate-setting policies of government agencies. Most export credit agencies are used to the comfort of government guarantees and are just beginning to accept the concept of nonrecourse or limited-recourse project finance. The IFC, therefore, has played an important catalytic role in power projects by attracting other investors.

A popular option today for power projects is based on the BOT model, by which a private company *builds, operates*, and, after several years, *transfers* to the government a privately financed power plant. The IFC has financed BOT projects for new power stations in Asia and Latin America and is currently considering a number of such power projects elsewhere, particularly in Eastern Europe and Africa.

Capital Markets

Capital markets development has been a major priority of the IFC's work. To date, the IFC has invested in over 180 private financial institutions in over 80 countries. In 1995, financial sector projects represented 23 percent of total project financing approved for the IFC's own account.[18]

Ability to funnel domestic savings into long-term investment is fundamental to a country's sustainable development. The IFC's capital markets operations emphasize mobilizing domestic savings within the capital markets of the developing countries themselves. In 1995, the IFC helped certain Latin American countries to introduce private pension funds to mobilize domestic savings.[19] In South Africa, a franchise fund will help finance small and medium-sized businesses.[20] It is the first fund in the world designed specifically to help individuals invest in franchises and will enable previously disadvantaged people to acquire their own business. In the West Bank and Gaza, establishment of the Arab Palestine Investment Bank will introduce financial services necessary to support the urgently needed private sector growth in the region.

The IFC has also been at the forefront of developing innovative channels for investor funds where traditional channels have not been available. During 1995, the IFC signed its first syndication of a structured U.S. commercial paper issuance facility, a $150 million issue for a Thai finance company, Finance One.[21] Such facilities will enable companies in developing countries to access the U.S. commercial paper market. Similarly, the Natwest/IFC Latin American Index Fund, also developed in 1995, will allow investors to gain exposure to emerging Latin American markets on an indexed basis.[22] The IFC also helped establish P.T. Citimas Capital in 1995—the first specialized securitization and credit enhancement institution in Indonesia.[23] Citimas is an example of the increasing role that securitization may have in the future of the IFC's work. Through securitization, the IFC can help companies raise more funds and strengthen its development role.

Small and Medium-Sized Enterprises

One of the less-well-known activities of the IFC is the assistance it provides to small and medium-sized enterprises in small countries and countries in transition, and those enterprises with little access to equity or long-term financing. Over the years, the IFC has invested in important activities to support such enterprises through its Project Development Facilities and Business Advisory Services.

The IFC's efforts in sub-Saharan Africa, through the African Enterprise Fund, are well known. A review of the IFC's experience with this operation confirms the critical importance of this work.[24] In addition, the Africa Project Development Facility helps entrepreneurs throughout Africa organize, diversify, and expand.[25] The African Management Services Company provides management training and management services for enterprises in Africa.[26] The South Pacific Project Facility, based in Australia, helps entrepreneurs in the South Pacific island countries identify and prepare small and medium-sized projects.[27] Through 1994, these facilities have assisted over 240 projects, raised $300 million in financing, and created or saved more than 23,000 jobs. Many ventures would not have gone ahead without these facilities.

The IFC is also planning to use its project development expertise and experience in direct lending to small and medium-sized enterprises in other regions. New facilities are currently being pursued in Indochina and other regions.

Environment

It is only in the last decade of the IFC's history that the environment became one of the criteria by which a project is appraised and evaluated. Apart from the obvious benefits and appeal of "green" projects, it makes

financial sense to look at environmental issues—the long-term profitability of an investment is closely linked to its environmental quality, which in turn entails properly managing raw materials, minimizing waste and pollution, avoiding contamination, increasing worker productivity through health and safety measures, and maintaining a good relationship with local communities. All IFC projects must comply with the relevant World Bank environmental, health, and occupational safety policies and guidelines.

The IFC screens all proposed investments to identify and manage environmental risks along with other credit risks. Projects are categorized at an early stage according to the project's potential impact on the environment.[28] Category A projects are those projects that could bring about significant environmental impacts; they may involve special concerns, such as resettlement of indigenous people. Category B projects are projects with specific environmental impacts that must be mitigated through predetermined performance standards and design criteria. Category C projects are those that do not result in any environmental impact at all. In addition, certain projects in the financial sector are designated as Category FI; these are typically projects that finance subprojects that may result in environmental impact. Power projects usually rank somewhere between Categories A and B.

The IFC requires a full environmental assessment study for Category A projects. An environmental analysis will be required for Category B projects. Finally, in the case of the FI projects, the IFC must be satisfied that the financial intermediary is capable of conducting environmental review of subprojects and is committed to doing so.

The IFC monitors the environmental performance of all projects during their implementation and, in some cases, throughout their operation. The environment division in the IFC's Technical and Environmental Department serves as a focal point for these activities.[29]

In recent years, many IFC member countries have begun to express interest in environmental issues. The IFC also has been receiving many inquiries from various nongovernmental organizations and members of the public on its policy-and project-specific information on the environment.

As a developmental institution dedicated to the private sector, the IFC's policy generally is not to disclose to the public any business or confidential information relating to projects. The rules of discretion and confidentiality, as applied by investment, merchant, and commercial banks, must also apply to the IFC in order for the IFC to work effectively and with credibility. Accordingly, until recently, the IFC did not disclose to

the public any information relating to a project prior to its approval by the Board of Directors. However, in response to environmental concerns expressed by IFC member countries, members of the public, and non-governmental organizations who legitimately wished to express their views for consideration by the IFC before a project was approved by the Board of Directors, the IFC decided to modify its policy on disclosure of information.

In July 1994, the IFC adopted a new Policy on Disclosure of Information. Under this policy, summary information on a project must be filed with the Public Information Center at least 30 days prior to the day on which the Board of Directors is to consider the project. In addition, for all Category A projects, the environmental assessment and executive summary are released to the Public Information Center at least 60 days in advance of such date. The IFC must receive the approval of the project sponsors to release such documents publicly.

The latest amendments to the Policy on Disclosure of Information were approved by the Board of Directors in December 1995. These amendments emphasize early release of relevant information and renewed focus on adequate public consultation during appraisal of projects, so as to help improve project design before a decision is made. The public consultation must be carried out in a culturally and socially acceptable manner and in accordance with the applicable laws and regulations. Consultation techniques include official review committees, social acceptance surveys, and, in areas where local communities are primarily illiterate, meetings with village elders. The environmental assessments for Category A projects are now available in the country where the project is to be located and also in the World Bank InfoShop. The full text of all information available at the World Bank InfoShop can also be accessed on the Internet.[30]

Apart from the IFC's efforts to work toward a greater degree of openness and transparency, the IFC continues to promote innovative environmental projects, such as ecotourism and waste water treatment projects. A recent ecotourism project illustrates the complexity of environmental issues arising from building a resort.

In 1995, the IFC supported a project to build a small ecotourism lodge on the beach of Panga ya Watoro, north of a national forest on a peninsula of Pemba Island in Tanzania.[31] The project is supported by a loan from the African Enterprise Fund. The lodge is expected to have a positive impact on the fishery resources of the peninsula and Pemba Island in general. However, because the lodge is near a forest, turtle nesting sites, and coral reefs, and, due to the environmental sensitivity of the area, the IFC categorized the project as having potential for diverse and significant

environmental effects (Category A).[32] To protect the habitat, the IFC is requiring that the project sponsors shield turtle nesting sites from construction and other activities; use special lighting to avoid disorienting nesting turtles and their hatchlings; and restore a coastal evergreen thicket that is used as a corridor for local animals, including an endangered species of bat.[33] The sponsors, who wish to make the lodge a world-class center for diving and marine research, plan to establish an environmental research station.[34]

With financial support from the IFC's Part I country members (the developed countries), the IFC continues to tackle global environmental issues on a local scale. For example, the IFC approved during the 1995 fiscal year an investment in a project in Egypt, where a company will convert its manufacturing process for compressors in order to use alternatives to chlorofluorocarbons, which are ozone-depleting substances.[35] A grant for the Poland Efficient Lighting Project will replace 1.15 million incandescent lights with energy-efficient compact fluorescent lamps over a two-year period.[36]

There are two sources of multilateral funding for these projects: the Global Environmental Facility (GEF) and the Multilateral Fund of the Montreal Protocol.[37] The GEF was established to enable eligible developing countries to meet the agreed incremental costs of compliance with the various environmental conventions.[38] The GEF is active in the areas of biological diversity, climate change, international waters, and ozone layer depletion. Both fund consultants who work with IFC staff to identify private sector projects eligible for their grants.[39]

Conclusion

In the last 40 years, the IFC has gained extensive hands-on knowledge of how to do business in developing countries. By assisting the flow of international financial resources and private sector entrepreneurship and know-how, the IFC has found solutions to the unique problems that affect private businesses in emerging economies. The IFC's activities reflect the belief that market forces must play a greater role in the economies of developing countries if sustained growth is to be achieved. In recent years, many emerging economies have come to share the IFC's belief and rewarded the IFC with many opportunities for assistance and cooperation. However, the IFC must look to the future and continue to ask how it can fulfill its role and meet new challenges in the rapidly changing and demanding world of economic development.

Foreword to Chapters 4 and 5

THOMAS C. BAXTER, JR.

Three basic themes interest central banks and their counsel: (i) monetary policy, (ii) banks and bank supervision, and (iii) the payment system. The third theme is the focus of Chapters 4 and 5. The payment system can be analogized to the circulatory system of an organism, the life blood that keeps the world's economic organism healthy and operating. If this analogy is correct, a loss of confidence in the payment system may cause other destructive effects in the world's economy. Such effects might include a breakdown in commerce, a cessation in commercial transactions, or an economic stagnation that would be of great concern to central banks and central bank counsel.

Public confidence in a payment system may wane if there is uncertainty about the risk of loss in particular transactions and who bears that risk. One way to ensure that public confidence in the payment system remains strong is to develop clear legal rules. Clarity in legal rules makes it easier for participants and central banks to evaluate, control, and, most importantly, limit the risks in various payments transactions.

When focusing on ways to minimize risk in the payment system, it is also important to consider the impact of globalization and technological advances. Business today is increasingly being transacted internationally. As business crosses national borders, so do the payments that are associated with such business. Cross-border payments involve, of course, the interaction between different legal systems and different currencies, thereby complicating the legal issues of interest to central bankers.

Along with globalization, technological advances also affect the way banks do business. Improvements in technology have increased access to information, thus enabling market participants to better understand credit risk. Technological advances also make it easier to transfer large sums quickly. Consequently, central bankers must think about the risks these advances may pose to the banking system. No longer is a "run on a bank" simply people queuing up in teller lines asking for their deposits back. Today, a far more serious threat exists. A "silent run" on a bank could occur by electronic transfers of money that quickly drain funds from a bank.

Globalization and technological advances play important parts in netting and foreign exchange settlement risk and electronic cross-border transactions, the topics of Chapters 4 and 5. These chapters assess the various risks involved in these transactions and analyze how different coun-

tries' legal systems affect these risks. The chapters demonstrate that a lack of clarity in legal rules makes it very difficult to evaluate, control, and, most important, limit the risk in these various payment transactions.

Chapter

4 Foreign Exchange Settlement Risk

ELIZABETH TIBBALS DAVY AND NIKKI M. POULOS[1]

Introduction

Risk associated with the settlement of foreign exchange transactions is a topic of concern to central bank counsel and is currently the focus of international attention. This chapter draws directly from the work of the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries (the Committee), as most recently reflected in the report published by the Bank for International Settlements (BIS), entitled *Settlement Risk in Foreign Exchange Transactions* (the Report).[2] In essence, the Report analyzes the existing arrangements for settling foreign exchange trades and offers practical approaches for reducing foreign exchange settlement risk. The approaches are grounded in the belief that individual banks and industry groups, with cooperation (and a little friendly encouragement) from central banks, can make important progress in reducing this risk.

This chapter focuses on the Report and then identifies legal issues raised by the Committee's specific findings and recommendations. While the Report itself does not address legal issues, successful resolution of some of the legal issues raised herein will be essential to the implementation of the Report's recommendations. While enormous progress has been made to increase legal certainty in recent years in areas such as netting, other issues, such as those related to payment finality and cross-border insolvency, remain largely unresolved. Coordinated international efforts to address some of these issues are currently under way and are a particular focus of national bank supervisors and central banks. Also addressed by this chapter are some challenges faced by private sector groups attempting to establish multicurrency foreign exchange clearing mechanisms.

The Report is based on the work of the Steering Group, which the Committee formed in June 1994 to build upon its past work and to develop a strategy for reducing foreign exchange settlement risk. The Report was released in March 1996 and is one of a series of efforts undertaken in the past twenty or so years to deal with issues raised by the globalization of financial markets. Payments issues in particular have come

into sharp focus in recent years, given the growth of cross-border financial activity and the worldwide interrelationship of payment and settlement systems. Today, markets are so interconnected that trouble originating in any market can spread quickly around the world. This is a concern to central bankers responsible for overseeing the smooth functioning of payment systems worldwide, as well as to managers of financial institutions. Settlement risk in the foreign exchange market is especially troublesome because its effects can be felt across national borders and can impact the financial system globally.

Foreign exchange trading has grown dramatically in the past 20 years. The operational capacity of banks to settle trades has greatly improved, but current settlement practices (as identified by a survey conducted by the Committee, which is addressed in some detail later) generally expose each trading bank to the risk of incomplete settlement. Given the estimated $1¼ trillion of foreign exchange trades arranged daily, the resulting large exposures raise significant concerns for individual banks and the international financial system as a whole. These concerns include the effects on the safety and soundness of banks, the adequacy of market liquidity, market efficiency, and overall financial stability.

As the Committee concluded, close cooperation among central banks, and between central banks and the private sector, is absolutely critical in addressing systemic risks arising from the expansion of cross-border payments and clearance and settlement systems. Unilateral action by a central bank would likely not accomplish very much in this area.

Settlement Risk Distinguished from Other Risks

Settlement of a foreign exchange trade requires the payment of one currency and the receipt of another. The principal risk in settlement of such trade is that one party would pay out the currency it sold but not receive the currency it bought. This is called foreign exchange or cross-currency settlement risk.

The Steering Group points out in the Report that foreign exchange or cross-currency settlement risk has a credit risk dimension, that is, whenever a party cannot condition its payment of the currency it sold upon final receipt of the currency it bought, it faces the possibility of losing the full principal value involved in the transaction. This may be viewed as a credit exposure to the counterparty equal to the full principal amount of the currency purchased.

This could, of course, also lead to *liquidity risk*. If a party does not receive the currency it purchased when due, it would need to finance the shortfall until its counterparty delivers the currency it owes.

Finally, the Steering Group identifies *other risks* raised by foreign exchange trading, such as *market risk*, which is the risk that the market will move against the nondefaulting party; *replacement risk,* or the risk of having to replace at current exchange rates an unsettled yet profitable foreign exchange transaction with a failed counterparty; and *operational risk*, the risk of incurring interest charges or other penalties for misdirecting or otherwise failing to make foreign exchange settlement payments on time because of an error or technical failure.

The Herstatt Episode

Foreign exchange settlement risk first came into sharp focus in 1974 with the collapse of Bankhaus Herstatt, a small bank in Cologne, Germany active in the foreign exchange market. Herstatt was closed by its banking supervisor at the end of the German business day. This was 10:30 a.m. New York time. Prior to the announcement of the closure, several of Herstatt's counterparties had irrevocably paid deutsche mark to Herstatt on that day anticipating that they would receive U.S. dollars later the same day in New York. Upon its closure, Herstatt's New York correspondent bank suspended outgoing U.S. dollar payments from Herstatt's account. This action left its counterparties exposed to credit and liquidity risk up to the full value of deutsche mark deliveries made. Moreover, banks that had entered into forward trades with Herstatt not yet due for settlement lost money in replacing the contracts in the market, and others had deposits with Herstatt. The Herstatt incident served to focus both public and private sector awareness on the problems created by settling different legs of the same transaction in different markets and time zones, leading unavoidably to counterparty settlement risk.

Group of Ten Initiatives to Address Concerns

In response to the Herstatt episode, the Group of Ten central banks began working together on supervisory issues, including foreign exchange market risk and the need for an international early warning system. Initially, this work was often associated with efforts to understand the benefits and risks of netting. The earlier work of the Group of Experts on Payment Systems resulted in the 1989 *Report on Netting Schemes*, also known as the "Angell Report."[3] This report analyzed the credit and liquidity risks experienced by participants in bilateral and multilateral netting arrangements for both interbank payment orders and forward-value contractual commitments, such as foreign exchange contracts. The Angell Report also identified a number of broader policy issues and expressed concern over the difficulty of providing effective oversight of cross-border netting systems. The Angell Report developed an agreed

language and understanding of netting, an important first step in dealing with a common technique in payments arrangements.

A committee headed by Alexandre Lamfalussy, general manager of the BIS, was set up by the Group of Ten governors to deal with the broader policy issues and concerns raised in the Angell Report. As a result of the committee's work, the BIS published a study on interbank netting schemes in 1990 known as the "Lamfalussy Report."[4] This report recommended a set of minimum standards for the operation of cross-border and multicurrency netting schemes, and principles for cooperative oversight by central banks.[5] The minimum standards are designed to ensure that participants and service providers produce arrangements that obtain the benefits of netting without introducing systemic risks. The Lamfalussy Report was a particularly important step in central bank cooperation for coping with payments system risks.

Because the Lamfalussy Report did not directly attack the issue of settlement risk in foreign exchange trades, the Committee on Payment and Settlement Systems published in 1993 a report entitled *Central Bank Payment and Settlement Services with Respect to Cross-Border and Multi-Currency Transactions*, commonly referred to as the "Noël Report."[6] This report was analytical in nature and outlined the thinking of the Group of Ten central banks on ways to address settlement risks. The analysis was designed to advance the current understanding of the issues involved in reducing or eliminating foreign exchange settlement risk and deliberately did not produce recommendations. Instead, it sought only to evoke industry reaction.

As mentioned, the Committee formed the Steering Group to build upon this past work and to develop a strategy for reducing foreign exchange settlement risk. This work resulted in the Report.

The Report on Settlement Risk in Foreign Exchange Transactions

This part focuses on specific aspects of the Report's findings and recommendations. First, the methodology identified by the Steering Group for measuring foreign exchange settlement exposure is outlined. Next, the key findings of a survey conducted by the Steering Group of 80 banks in the Group of Ten countries on current market practices for managing settlement risks are reviewed. In particular, the current efforts of individual banks to control risk and improve settlement practices, and those of banks collectively to develop risk-reducing multicurrency services, are addressed. Then, a brief description of the three-step strategy proposed by the governors of the Group of Ten central banks for reducing foreign

exchange settlement risk is set forth. Finally, the legal issues raised by the Report are analyzed.

Methodology for Measuring Foreign Exchange Settlement Exposure

The following is an overview of the methodology used by the Steering Group for measuring foreign exchange settlement exposure. The Group began by defining the nature and scope of the exposure. The definition is as follows:

> A bank's actual exposure—the amount at risk—when settling a foreign exchange trade equals the full amount of the currency purchased and lasts from the time a payment instruction for the currency sold can no longer be cancelled unilaterally until the time the currency purchased is received with finality.[7]

The Report points out that for a bank to measure current and future foreign exchange settlement exposures in this way, it would need to recognize the changing status of each of its trades during the settlement process. In other words, a bank would need to be able to distinguish and track when its payment instructions can no longer be cancelled unilaterally and when it has received currency with finality. In order to accomplish this, a bank needs to understand the legal status of the trade. The Report classifies a trade's status according to five broad categories:

- Status R (revocable). Status R, or revocable, relates to when a "bank's payment instruction for the sold currency either has not been issued or may be unilaterally cancelled without the consent of the bank's counterparty or any other intermediary. The bank faces no current settlement exposure for this trade."[8]

- Status I (irrevocable). Status I, or irrevocable, is when a "bank's payment instruction for the sold currency can no longer be cancelled unilaterally either because it has been finally processed by the relevant payments system or because some other factor (e.g., internal procedures, correspondent banking arrangements, local payments system rules, laws) makes cancellation dependent upon the consent of the counterparty or another intermediary; the final receipt of the bought currency is not yet due. In this case, the bought amount is clearly at risk."[9]

- Status U (uncertain). Status U means the status is uncertain. "The bank's payment instruction for the sold currency can no longer be cancelled unilaterally; receipt of the bought currency is due, but the bank does not yet know whether it has received these funds with finality. In normal circumstances, the bank expects to have received

the funds on time. However, since it is possible that the bought currency was not received when due (e.g., owing to an error or to a technical or financial failure of the counterparty or some other intermediary), the bought amount might, in fact, still be at risk."[10]

- Status F (fail). Payment is in a Status F, or a fail, when the "bank has established that it did not receive the bought currency from its counterparty. In this case the bought amount is overdue and remains clearly at risk."[11]

- Status S (settled). Finally, a trade is considered settled, or is in Status S, when the "bank knows that it has received the bought currency with finality. From a settlement risk perspective, . . . the bought amount is no longer at risk."[12]

The drafters of the Report concluded that once a bank determines the status of its trades, it can easily calculate its foreign exchange settlement exposure. Banks that always identify their final and failed receipts of bought currencies as soon as they are due can determine their exposures exactly. For these banks, current exposure equals the sum of their Status I and F trades, that is, those trades for which the bank has issued an irrevocable payment instruction for the sold currency (but has not received the bought currency) and those trades that have failed. In contrast, banks that do not immediately identify their final and failed receipts cannot pinpoint the exact size of their foreign exchange settlement exposures.

Faced with this uncertainty, a bank should be aware of both its minimum and maximum potential foreign exchange settlement exposure. The Report provides general guidelines for a bank to follow to measure its minimum and maximum potential exposure on the basis of the current status of its unsettled trades. Minimum exposure would be equal to the sum of Status I and F trades, and maximum exposure would be those trades plus any Status U trades.[13]

Findings of the Report Based on Market Survey

The drafters of the Report conducted a survey of approximately 80 banks in the Group of Ten countries to understand how market participants currently measure and manage settlement risk. The findings of the survey can be summarized as follows:

Finding: Foreign exchange settlement exposure is not just an intraday phenomenon: current foreign exchange settlement practices create interbank exposures that can last, at a minimum, one to two business days, and it can take a further one to two business days for banks to know with certainty that they received the currency they bought.[14]

Explanation: The Report indicates that for most banks surveyed, and in every Group of Ten country, the minimum foreign exchange settlement exposure of an individual spot or forward trade currently lasts for between one and two business days. In addition, it notes that it can take an additional one to two business days for many banks to establish whether they have received the bought currency on time. Furthermore,

> the often lengthy duration of foreign exchange settlement exposure reflects the fact that current practices for handling payments and receipts were designed more for operational efficiency . . . than for controlling settlement exposures . . . Once they begin, certain automated procedures can make it difficult, if not impossible, for a bank or its correspondent to cancel unexecuted payment instructions even before settlement day. This can increase the duration of foreign exchange settlement exposures by creating overly restrictive unilateral payment cancellation deadlines.[15]

Finding: Given current practices, a bank's maximum foreign exchange settlement exposure could equal, or even surpass, the amount receivable for three days' worth of trades, so that at any point in time—including weekends and public holidays—the amount at risk to even a single counterparty could exceed a bank's capital.[16]

Explanation: The survey also found:

> The size of a bank's total foreign exchange settlement exposure depends directly on the duration of the settlement exposure of each of its trades. For instance, if a bank's minimum settlement exposure for a single foreign exchange trade lasts 48 hours, at least two days' worth of trades would always be at risk. In addition, if it takes, for example, another 24 hours to verify the final receipt of each purchased currency, a further day's worth of trades ***might*** still be at risk.
>
> No comprehensive statistics are yet available on the banks' actual levels of foreign exchange settlement exposure, partly reflecting the fact that most banks currently do not measure them properly, if at all. Nevertheless, several banks indicated that their current exposures can reach very high amounts. For instance, some banks said that they routinely settle foreign exchange trades worth well over US$1 billion with a single counterparty on a single day. If current practices can transform this level of activity into an actual foreign exchange settlement exposure that is two to three times this amount, bilateral foreign exchange settlement exposures could be large in relation to a bank's capital and could far exceed the short-term credit exposure a bank incurs in other activities with the same counterparty.[17]

Finding: Individual banks could, if they so choose, significantly reduce their own exposures and systemic risk more broadly by improving their back office payments processing, correspondent banking arrangements, obligation-netting capabilities, and risk management controls.[18]

Explanation:

> The survey indicated that a bank's foreign exchange settlement practices can greatly influence the size of its exposures. One way a bank can lower its

> exposure is by changing the timing of its unilateral payment cancellation deadlines and of its identification of final and failed receipts.[19]

This could require changes to a bank's own settlement practices and possibly correspondent arrangements. Another way to lower exposures "is by legally binding netting of the daily settlement obligations arising out of a bank's foreign exchange trades rather than settling each trade individually."[20] This reduces the amount at risk by lowering the number and size of payments needed to settle on a trade-by-trade basis.

Finding: Well-designed multicurrency services, such as multicurrency settlement mechanisms and bilateral and multilateral obligation netting arrangements, could greatly enhance the efforts of individual banks to reduce their foreign exchange settlement exposures.[21]

Some major banks are concerned about the sizable foreign exchange settlement risks they face and are actively pursuing ways to improve their own settlement practices and to collectively develop risk-reducing multicurrency services.

Nevertheless, despite their considerable capacity to reduce foreign exchange settlement risk through individual and collective action, many banks remain skeptical about devoting significant resources to such efforts.

Explanation:

Risk awareness. The survey revealed:

> Although most banks are familiar with the concept of foreign exchange settlement risk, not all banks have a single officer who understands the entire settlement process and the risks it entails, so that meetings with some banks for the purpose of the market survey required the presence of representatives from several different departments in order to cover all aspects of the subject. Moreover, some market participants indicated that the senior executives of their banks had never been fully briefed on the foreign exchange settlement process and the associated risks.[22]

Risk measurement. In addition, the survey revealed:

> Overall, many banks currently underestimate the duration and size of their foreign exchange settlement exposure by treating it as an intraday amount no larger than a single day's expected receipts. Only a few banks treat irrevocable payment instructions issued prior to settlement day as part of their foreign exchange settlement exposure. In addition, most banks do not appear to incorporate due but unverified receipts, let alone failed receipts, in their measures of outstanding exposure with a counterparty. As a result, many banks do not recognise that they can routinely incur foreign exchange settlement exposures equivalent to several days' trades, and that these exposures can persist overnight, and therefore over weekends and holidays.[23]

The Report reveals that only a few banks surveyed expressed interest in implementing an internal measurement system like the one described previously for defining and measuring foreign exchange settlement exposure. Banks seem to be concerned mostly "about the cost of such a system, particularly one that would continually update a bank's global exposure as it executes each new trade and as each unsettled trade moves through the settlement process."[24]

Risk controls. The survey indicated that some banks do not impose limits at all on their foreign exchange settlement exposures, no matter how they are measured. As for those banks that do have limits, some use them effectively, while others set them at extremely high levels or waive them altogether for their largest trading partners.

> In addition, some banks impose binding settlement limits, particularly on certain counterparties or in special circumstances, while others use such limits only as guidelines. In general, banks with foreign exchange settlement limits tend to set them with an eye to preventing unusual trading activity rather than containing credit and liquidity exposure.[25]

Consequently, limits and actual foreign exchange settlement exposures can be much higher than those seen for products with similar risks, such as overnight placements and deposits involving the same counterparties.

It appears from the survey that, while some banks are considering imposing new settlement limits, they are concerned that it would be difficult to hold their counterparties to such limits if others in the market did not do the same thing.

Prospects for individual action. Also, many banks seem not to have "clearly established responsibility for managing foreign exchange settlement risk within their institutions, and so have not created the authority and incentives to control it prudently. While some bankers plan to spend the necessary time and money to improve their settlement practices, others do not and see little incentive to change their practices without a strong mandate from their senior management."[26]

Description of Group of Ten Strategy as Set Forth in the Report

This part examines the Report's specific recommendations. Building upon the results of the market survey and the past work of the Group of Ten central banks on international payments arrangements (most notably the Angell, Lamfalussy, and Noël Reports), the Committee on Payment and Settlement Systems constructed, and the Group of Ten governors endorsed, the following three-track strategy:

- action by ***individual banks*** to control their foreign exchange settlement exposures;
- action by ***industry groups*** to provide risk-reducing multicurrency services; and
- action by ***central banks*** to induce rapid private sector progress.[27]

Action by Individual Banks to Control Their Foreign Exchange Settlement Exposures

The Report urges individual banks to take immediate steps to improve their current practices for measuring and managing their foreign exchange settlement exposures. The Report suggests the following:

- measuring foreign exchange settlement exposures as trades move through the settlement process;
- applying a credit control process to foreign exchange settlement exposures consistent with its control process for managing other credit exposures. For this to work, a bank would need to accept the proposition that foreign exchange settlement exposure represents the same credit risk, and the same probability of loss, for the bank as a loan of identical size and duration with the same counterparty; and
- reducing excessive foreign exchange settlement exposures for a given level of trading by improving settlement practices.[28]

For instance, by eliminating overly restrictive payment cancellation deadlines and shortening the time it takes to identify the final and failed receipt of bought currencies, a bank could lower its actual and potential foreign exchange settlement exposure for the same level of foreign exchange trading. Depending on a bank's trading pattern, the use of available bilateral or multilateral obligation netting arrangements could reduce exposures even further. If necessary, in certain cases a bank may further protect itself against excessive foreign exchange settlement exposures by, for instance, requiring collateral from its counterparties.[29]

Central Bank Policy Perspective on Individual Action

This type of private sector response focused at the individual bank level provides certain advantages and benefits from a central bank policy perspective. For instance, it can be effected immediately and makes use of the traditional strength of individual banks in reaching informed credit judgments and in pricing and controlling credit risk properly. It allows a bank to make more measured adjustments to its foreign exchange settlement exposures with counterparties in response to its evolving financial condition, which could help stabilize money markets, reduce liquidity pressures, and contain systemic risk at times of market stress.[30]

Moreover, the envisioned action by individual banks would not require modification of the underlying payments system infrastructure, so that domestic monetary policy implementation should not be affected. Finally, a marketwide increase in the desire of individual banks to lower their foreign exchange settlement exposures should also encourage competition in the quality of correspondent banking services and stimulate private sector innovation.[31]

In focusing on action that could be taken by individual banks to reduce foreign exchange settlement exposure, the drafters of the Report found that much promising work on foreign exchange settlement risk had already begun. The New York Foreign Exchange Committee (the NYFEC), a group sponsored by the Federal Reserve Bank of New York, which includes as its members individuals from commercial banks, investment banks, and other private organizations, released a study showing that foreign exchange settlement risk, long believed to be an intraday risk, is in fact an overnight risk.[32] This study documented for the first time the considerable impact of market practices on the size and duration of foreign exchange settlement exposure. It included recommendations on how private sector market participants can themselves reduce foreign exchange settlement risk by improving internal procedures.[33] The NYFEC developed over a dozen recommended best practices to help the industry and individual banks reduce foreign exchange settlement risk.

The study also found that netting is a powerful tool for active market makers. Legally binding netting of payments enables market makers to reduce significantly the enormous sums that are at risk on any given day.

Finally, the NYFEC concluded that for most firms the current finality rules of the local payments systems are an important factor in determining the extent of settlement risk. In fact, for firms operating with close-to-current best industry practices, settlement risk could be decreased if full intraday finality prevails. When it does, final payments could, if necessary, be made and reconciled much sooner. This change, in turn, would shorten the duration of settlement risk.

Action by Industry Groups to Provide Risk-Reducing Multicurrency Services

In addition to encouraging action by individual banks, the Report encourages industry groups to develop multicurrency services that "would contribute to the risk reduction efforts of individual banks and reduce systemic risk more broadly."[34] This recommendation recognizes "the significant potential benefits of multicurrency settlement mechanisms and bilateral and multilateral obligation netting arrangements."[35] The Report reflects the view of the Group of Ten central banks that "such

services would best be provided by the private sector rather than the public sector."[36]

"Foreign exchange settlement exposure could be attacked at its source by creating one or more multi-currency settlement mechanisms that establish a direct relationship between the payment of one currency and the receipt of another."[37] The Noël Report asserted that this kind of delivery-versus-payment (or, in this context, payment-versus-payment (PVP)) mechanism would assure participants that "a final transfer in one currency occurs if and only if a final transfer of the other currency takes place."[38] The drafters of the Report indicate that they believe a multicurrency PVP settlement mechanism can potentially eliminate foreign exchange settlement exposure. However, they indicate that a PVP mechanism "would not necessarily reduce or eliminate the liquidity or other risks that can arise when settling foreign exchange trades . . ."[39] PVP also does not address the practical timing problems of coordinated cross-border payments and settlements. Central banks considering a potential multicurrency system should evaluate the proposed design of the system to ensure that it does not increase certain risks while reducing others.

The Group of Ten central banks recognize that "the successful creation of multi-currency settlement mechanisms would require cooperation between market participants and central banks, since all these parties need to be concerned with the safety and soundness, as well as the economic viability, of any multi-currency settlement system."[40] At the end of this chapter, some of the Committee's specific recommendations for central bank cooperation are addressed.

The Report also points out that the risk-reducing benefits of any multicurrency *settlement* mechanism can be magnified when combined with bilateral or multilateral *obligation* netting of the underlying foreign exchange trades. Legally valid obligation or payment netting reduces the number and size of settlement flows and, therefore, reduces the intraday liquidity needs for settling those trades through a multicurrency settlement mechanism. Depending on the circumstances, however, problems in either the netting arrangement or the settlement mechanism can have an adverse impact on the other. Accordingly, the integrity of both the settlement mechanism and the netting arrangement must be sufficiently strong to ensure that the combined arrangement does not create greater problems than it solves.

Bilateral Netting Services

FXNET,[41] the Society for Worldwide Interbank Financial Telecommunication (SWIFT), and VALUNET currently provide bilateral obligation netting services to many banks.[42] In addition, many banks have set up on

their own bilateral netting arrangements using a standardized contract, such as the International Foreign Exchange Master Agreement.[43]

> However, despite the potential risk-reducing benefits, the market survey indicated that not all banks use bilateral obligation netting agreements. When they do net, more often than not their netting is limited to close-out provisions (mainly to take advantage of favourable capital treatment of netted positions or to improve their leverage ratios), while routine settlements continue to be conducted on a gross, trade-by-trade basis. Obligation netting[44] is mostly confined to the largest banks and their largest counterparties.[45]

Multilateral Netting and Settlement Services

> ECHO (Exchange Clearing House) began operations in August 1995 and the proposed Multinet International Bank hopes to start in 1996.[46] Both systems are designed to transform bilaterally arranged individual foreign exchange trades into multilateral net settlement obligations and to provide risk controls that ensure the timely settlement of these obligations. In essence, these controls are designed to reduce credit and liquidity risks by assuring participants that the final settlement of each currency will take place even if a participant in the group is itself unable to settle its obligations on the due date.
>
> ECHO began operations with 16 participant users in 8 countries netting trades in 11 currencies. ECHO hopes to expand its services to banks in more than 20 countries for trades in 25 currencies. Multinet plans initially to provide services to 8 banks in North America for their trades in U.S. and Canadian dollars and other major currencies within the first year. Multinet also hopes to add further currencies and participants in other countries over time. It may be noted that central banks have successfully used the minimum standards and cooperative oversight principles set out in the Lamfalussy Report when reviewing these systems.[47]

Other Multicurrency Settlement Mechanisms

The "Group of Twenty," formed in 1994 and composed of international commercial banks from Asia, Europe, and North America, has actively been exploring other possible multicurrency settlement mechanisms. The purpose of the group is to develop private sector mechanisms for reducing risk and increasing efficiency in the clearance and settlement of linked transactions, primarily originating from foreign exchange activity.[48]

> Rather than directly netting the underlying foreign exchange trades, the models currently under study could be designed to support the settlement of individual trades or trades which have already been netted under other bilateral or multilateral obligation netting arrangements. Although these multi-currency settlement mechanisms would not, by themselves, provide the risk-reducing benefits of obligation netting, they could lower credit risks by assuring participants that the final transfer of one currency will occur if

and only if the final transfer of the other relevant currency also occurs. Multi-currency settlement mechanisms could also, if designed accordingly, lower liquidity risks by assuring participants that if they settle their payment obligations then they will receive their expected funds on time.[49]

Prospects for Collective Action

The Report points out that, although some of these industrywide initiatives are well under way, it appears:

> Many banks remain skeptical about the business case for committing resources to efforts to reduce foreign exchange settlement exposures. As a result, many individual banks have been slow to join these efforts. Without adequate motivation for a sufficient number of foreign exchange market participants to support and use one or more of these current or prospective industry-wide multi-currency services, their short-term (let alone long-term) viability is uncertain.[50]

Action by Central Banks to Induce Rapid Private Sector Progress

The final section of the Report that is to be addressed here outlines proposals for central bank involvement in encouraging rapid private sector progress in this area. The Report encourages central banks to facilitate progress by promoting private sector understanding of what banks can do individually and collectively to reduce foreign exchange settlement exposure. Central banks are also encouraged "to work cooperatively with industry groups seeking to develop well-constructed multi-currency services (e.g., multi-currency settlement mechanisms and bilateral or multilateral multi-currency obligation netting arrangements) that would be widely available and would help banks control their foreign exchange settlement exposures on a routine basis."[51]

Most notably, the Group of Ten central banks have indicated a willingness to cooperate with industry groups in several ways, including

- extending the operating hours of domestic payments systems;
- clarifying and, where possible, resolving legal issues and cross-border collateral issues; and
- considering, where appropriate, granting access to settlement accounts and central bank credit and liquidity facilities to sound multicurrency settlement mechanisms or to their members.[52]

Finally, the Report indicates that the Group of Ten central banks plan to facilitate private sector action by seeking the following key enhancements to national payments systems:

- Clarification of the times at which payment instructions become irrevocable and receipts become final in the settlement of foreign exchange

transactions through home-currency payments systems or book-entry transfers on the accounts of correspondent banks

- Provision, where not now available in at least one large-value payments system, of an intraday final transfer capability or its equivalent
- Removal of obstacles (e.g. early cut-off times for third-party transfers) that inhibit payments system direct members from acting upon late-day customer payment instructions for same-day value
- Strengthening, as necessary, of the risk management arrangements of privately operated systems used to settle foreign exchange transactions.[53]

Domestic Strategies

In addition to these measures, the Report indicates that "each central bank, in cooperation, where appropriate, with the relevant supervisory authorities, will choose the most effective overall strategy to stimulate satisfactory private sector action over the next two years in its domestic market."[54]

This strategy could include, after proper consultation,

supervisory measures to persuade individual banks to control their foreign exchange settlement exposures. If appropriate and feasible, one or more of the following measures could be taken:

- Supervisory guidelines for measuring foreign exchange settlement exposures in a manner consistent with the proposed methodology
- Regular confidential reporting of properly measured foreign exchange settlement exposures
- Regular public disclosure of properly measured foreign exchange settlement exposures
- Supervisory guidelines regarding the prudential management and control of properly measured foreign exchange settlement exposures
- Verification of compliance with the selected measures through bank examination and audit reports

If necessary, one or more of the following stronger supervisory measures might also be considered:

- The enforcement, by statute where available, of the use by individual banks of mechanisms to control their properly measured foreign exchange settlement exposures. This could include the setting of formal limits on those exposures
- Consideration, by agreement with banking regulators (G-10 and EU), of foreign exchange settlement risk in the set of risks subject to capital adequacy requirements

- The enforcement or imposition (by agreement with the relevant supervisors) of comparable measures applying to non-bank regulated financial institutions active in the foreign exchange market[55]

Central Bank Perspective on Central Bank Action

The views of the Group of Ten central banks on the strategy just described may be summarized as follows:

- The private sector should be encouraged and supported to improve settlement practices in individual institutions and on a marketwide basis.
- The home country central bank or the appropriate supervisory authorities should induce action by individual banks.
- "At the industry group level, central banks plan to cooperate, where appropriate and feasible, with those existing and prospective private sector groups that would like to provide risk-reducing multi-currency services. . . . When working with industry groups to bring about the identified key enhancements to national payments systems, central banks would need to guard against possible side effects."[56]
- "The Group of Ten central banks believe that the private sector can adequately address the systemic risk inherent in current practices for settling foreign exchange transactions."[57] Through the Committee on Payment and Settlement Systems, these banks will closely monitor progress during 1996–98 and assess the need for further action.

Legal Issues Raised by the Foreign Exchange Settlement Risk Report

Several legal issues are raised by the Report's recommendations.

Finality and Choice of Law

The Report urges a bank to distinguish and track when its payment instructions can no longer be cancelled unilaterally and when it has received currency with finality.[58]

In order to track the status of its trades to finality, a bank will have to resolve two significant legal issues: first, it will have to determine with some degree of certainty what substantive law will govern its rights and duties and those of its counterparties and intermediaries; and second, the bank will have to determine when and whether a sufficient degree of finality has been achieved under the applicable law.

The choice of law question, as it relates to the finality of payment transfers, could be addressed if countries adopted choice of law provisions such as those in the 1992 Model Law on International Credit Transfers (the Model Law) prepared by the United Nations Commission on International Trade Law (UNCITRAL).[59] No country has adopted a law similar to the Model Law (other than the United States, in the form of Article 4A of the Uniform Commercial Code).[60] The Model Law and Article 4A are similar on the choice of law issue.[61]

The basic rule set forth in Article 4A on choice of law is that parties to a funds transfer are free to choose the law of any jurisdiction to govern their rights and obligations.[62] This applies equally to the choice of substantive law selected by the rules of a funds transfer system, which would apply to participating banks and a nonparticipant party (for example, originator, other sender, receiving bank, or beneficiary) to a funds transfer that has notice that the funds transfer system might be used for all or part of the transfer.[63] The rights and obligations covered by these choice of law rules would include whether and when a payment order becomes irrevocable.

Where a conflict of laws exists, for example, in the case where settlement of a foreign exchange transaction involves two funds transfer systems with differing choice of law provisions in their rules, Article 4A specifically provides that the matter in issue is governed by the law of the selected jurisdiction that has the most significant relationship to the matter in issue.[64] This rule adopts the "most significant relationship" test that seeks to break a deadlock by supporting the substantive rules of the jurisdiction with the greatest policy interest in the underlying dispute.

Where no choice of law exists, in either an agreement between the parties or a funds transfer system rule, Article 4A provides that the law of the jurisdiction in which the receiving bank is located governs the rights and obligations of the sender and the receiving bank.[65] For purposes of determining location, a branch or separate office of a bank is viewed as a separate bank.[66]

With respect to finality, if the parties cannot determine whether a particular payment transfer will achieve finality under the applicable substantive law, their efforts to reduce foreign exchange settlement exposure may be for nothing. Generally, finality may be defined as the point at which an irrevocable and unconditional transfer effects a discharge of the obligation to make the transfer.[67] A credit transfer might be considered final when, as a matter of the governing law, the originator's payment order becomes irrevocable, the beneficiary's bank has unconditionally assumed the obligation to pay the beneficiary, and the beneficiary has unconditionally agreed to accept the credit institution's obligation in discharge of

the originator's payment obligation.[68] This type of finality would define where and when, as a matter of ordinary commercial law, credit risk comes to rest in a particular transaction. It is that point that must be defined with sufficient certainty for a bank to effectively measure its foreign exchange settlement exposure. Essentially, the exposure is "live" from the time the bank issues an irrevocable payment order with respect to the sold currency until it receives the bought currency with finality.

In the United States, efforts to harmonize domestic rules governing wholesale wire credit transfers resulted in Article 4A. The law covers Fedwire and the Clearing House for Interbank Payments System (CHIPS). The purpose of the law was to promote efficiency in, and bring certainty to, the law governing wholesale funds transfers. Under Article 4A, a funds transfer is completed when a beneficiary's bank has accepted a payment order for the benefit of the beneficiary.[69] Once the beneficiary's bank accepts the payment order, as a general rule, it cannot be cancelled or amended.[70] It should be noted, however, that some uncertainty exists in the United States as to the applicability of Article 4A to foreign exchange transactions. Some courts have held that Article 2 of the Code, which relates to the sale of "goods," applies instead.[71] Efforts are under way to clarify the applicability of Article 4A to foreign exchange transactions.

Finality may also be threatened by the application of noncontractual legal powers. For example, so-called zero-hour bankruptcy rules can cause transfers that achieved "contractual finality" between the zero hour and the moment of bankruptcy to be reversed as a matter of bankruptcy law. The draft proposal for an EU directive on settlement finality and collateral security[72] would specifically supersede any zero-hour bankruptcy rule that would have a retroactive effect on a participant's rights and liabilities in connection with EU payment systems.[73]

Netting

The Report also points out the importance of netting. Specifically, the Report states that the risk-reducing benefits of any multicurrency *settlement* mechanism can be magnified when combined with bilateral or multilateral *obligation* netting of the underlying foreign exchange trades.[74] Banks can also bilaterally net the settlement obligations arising out of their foreign exchange trades rather than settling them on a trade-by-trade basis. Such bilateral obligation netting could directly reduce the amount of risk by lowering the number and size of payments that would otherwise be needed to settle the underlying transactions. In order for netting to provide the benefits discussed by the Report, the netting must have a sound legal basis. A greater degree of legal certainty has been

introduced through recent statutory developments that serve to strengthen the legal foundation for netting in the United States.

The netting provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)[75] apply to bilateral netting contracts between financial institutions and multilateral netting contracts among clearing organization members.[76] Title IV of FDICIA makes clear that netting contracts are enforceable notwithstanding any other provision of law.[77]

The term "netting contract" covers agreements to net payments as well as to net and closeout over-the-counter and other transactions.[78] The term also includes the rules of a clearinghouse.[79]

FDICIA defines the term "financial institution" as a depository institution, a securities broker or dealer, a futures commission merchant, and other institution as determined by the Board.[80] The Board has expanded this definition through its promulgation of Regulation EE to include a broader range of market participants.[81] Regulation EE provides that any entity that meets certain tests based on market activity would qualify as a financial institution under FDICIA.[82] Most dealers in the over-the-counter derivative and foreign exchange markets would qualify as financial institutions under either the statutory or regulatory definition.

Since the publication of the Lamfalussy Report,[83] the legal status of netting has noticeably improved in most of the Group of Ten countries, in particular due to new legislation. Specifically, Belgium,[84] Canada,[85] France,[86] Germany,[87] the Netherlands,[88] Sweden,[89] Switzerland,[90] the United Kingdom,[91] and, as just noted, the United States[92] have enacted legislation to ensure the enforceability of netting arrangements or closeout mechanisms. New legislation on netting is envisaged in other countries. In Japan, no change in legislation is envisaged for the time being, because netting under existing rules for setoff is considered to have a sufficient legal basis.

In the Group of Ten countries, bilateral netting arrangements for payments exist and are in common usage. Bilateral payment netting seems to rely on well-founded legal mechanisms, such as novation, setoff, or current account,[93] which have their sources in general (civil or commercial) legislation or in long-established jurisprudence.

The bankruptcy laws of some Group of Ten countries include a zero-hour rule, which voids payments of an insolvent entity with retroactive effects to the zero hour on the day of commencement of an insolvency procedure. The effect of such a retroactive rule is that the receiver is either permitted, or required to seek, reimbursement of any payment made on that day by the insolvent debtor and, therefore, may, or must,

challenge the results of netting arrangements through which such payments have been made. Some of these countries have enacted specific provisions to overcome the zero-hour rule as far as interbank payments are concerned.

Multilateral netting of financial obligations is a largely untested field because of lack of both practical experience and judicial decisions. The legal analysis of such netting arrangements may not be very different from the analysis concerning bilateral netting of financial obligations.

Cross-Border Issues

Cross-border issues arise when there is a conflict between the law governing the netting arrangement and the potentially different laws applicable to the parties, particularly in connection with bankruptcy. The problem becomes even more complex by the fact that there is no uniformity in the determination of the law applicable to the bankruptcy of a party in a netting arrangement of an international nature. It is possible that several bankruptcy courts at once may consider themselves as having jurisdiction. This depends mainly on which principle of international bankruptcy law is applied in a particular jurisdiction.

Two main systems exist in the Group of Ten countries—the universality approach and the territoriality approach. The universality approach means that domestic insolvency proceedings also include, in theory, assets located abroad and that winding-up proceedings by domestic courts are conducted on a global basis. Under the territoriality approach, bankruptcy proceedings are effective only in the country in which they are opened, and, therefore, proceedings also have to be opened in every country in which the bankrupt holds realizable assets. It should be noted that many variants of each system exist, and "in practice most developed states adopt a combination of these extremes."[94]

International Coordination of Insolvency Legislation

Europe

In Europe, several efforts have been made to coordinate insolvency legislation. The Convention on Insolvency Proceedings (the Convention)[95] and the draft Winding-Up Directive[96] are of particular interest. The Convention had been signed by all member states of the European Union, except the United Kingdom, Ireland, and the Netherlands, by April 1996. However, since not all the EU member states signed the Convention by the May 23, 1996 deadline, it did not enter into force.[97]

Both the Convention and draft Directive apply the insolvency law of a bankrupt person's home state across Europe, regardless of the location of the assets and the persons who have dealt with the bankrupt.[98] Under the Convention, secondary proceedings can sometimes take place in states where there are "establishments."[99] Establishment is defined as "any place of operations where the debtor carries out a non-transitory economic activity with human means and goods."[100] Secondary proceedings begun after insolvency proceedings have started in the home state can only be liquidation proceedings.[101] The Convention applies to all entities except banks, insurers, mutual funds, and investment firms.[102]

There is a list of issues concerning those that the Convention may apply instead of the home state law, the law of another contracting state. These issues include security rights,[103] contractual netting,[104] retention of title,[105] protection of financial markets,[106] employees' rights,[107] and the right to attack preinsolvency transactions.[108] It should be noted that because of the uncertainty about the Convention's provision on setoff,[109] it is unclear whether the Convention would have any effect on netting agreements.

The Winding-Up Directive applies to insolvencies of banks.[110] It is still in draft but is progressing rapidly toward a common position agreed by the EU member states, from which the formal EU legislation process will begin. The Winding-Up Directive contains an express provision that ensures that the effect of insolvency proceedings on contractual netting agreements is to be governed by the law of the netting agreement.[111]

UNCITRAL

The UNCITRAL Working Group on Insolvency Law is currently working on an international insolvency law to take the form of an international agreement, an international law, or a treaty. The work is at its early stages. One of the issues that will have to be discussed at great length involves the provision of an automatic stay.[112] Under U.S. law, financial contracts are exempt from automatic stay.[113]

Access to Collateral

Important legal issues also arise with respect to collateral. Financial market participants and foreign exchange clearing organizations must satisfy themselves with a high degree of certainty of their ability to retain, liquidate, and apply collateral pledged to them by counterparties to secure their obligations under netting contracts. In order to be assured that collateral security will be available in the event of insolvency of a counterparty, it is necessary to determine that the insolvency laws applicable to that counterparty will not hinder or delay access to collateral.

Once a counterparty is declared insolvent, several events can occur that could potentially hinder the nondefaulting counterparty's rights in the collateral. For example, an automatic stay, or the receiver's right to take possession of all the assets of the insolvent counterparty (including collateral pledged by it to secure its obligations under a netting agreement), poses serious problems for the solvent party.

In the United States, legislation was enacted that has addressed these problems by giving special protections to qualified financial contract counterparties. Special provisions were added to the Federal Deposit Insurance Act (which covers insured depository institutions) in 1989 protecting qualified financial contracts.[114] A qualified financial contract is a securities contract, a commodity contract, a repurchase agreement, a swap agreement, or any similar agreement as determined by the Federal Deposit Insurance Corporation (FDIC).[115] The FDIC, in 1995, adopted a rule to include spot and other short-term foreign exchange agreements and repurchase agreements on qualified foreign government securities within the definition of qualified financial contract.[116]

Qualified financial contract counterparties retain certain rights under their contracts with insured depository institutions, subject to certain transfer powers of the FDIC. These rights may differ depending on whether the institution is in receivership or conservatorship. Specifically, in a receivership a qualified financial contract counterparty may exercise (i) any right to terminate or liquidate a qualified financial contract that arises upon the appointment of the FDIC as receiver, (ii) any right under a security agreement related to such a qualified financial contract, or (iii) any right to offset or net out obligations under a qualified financial contract.[117] The rights of qualified financial contract counterparties versus a conservator are subject to the FDIC's authority to enforce a contract notwithstanding any contractual provision that allows termination and closeout solely by reason of the appointment of a conservator.

The United States Bankruptcy Code covers bankruptcy proceedings of individuals, partnerships, and corporations (other than depository institutions and insurance companies).[118] The Code provides for an automatic stay of all actions against the debtor or the property of an estate upon the filing of a petition.[119] However, there are exceptions to the automatic stay in the Code, and there are provisions permitting the setoff[120] and termination of specific types of financial contracts.[121] These exceptions are available only for specific types of counterparties. They are: (i) securities contracts by stockbrokers, financial institutions, or securities clearing agencies; (ii) commodity contracts or forward contracts by commodity brokers or forward contract merchants; (iii) repurchase agreements by repo participants; and (iv) swap agreements by swap participants.[122]

Pledging of Securities

Financial market participants also need to determine in advance with sufficient certainty the substantive law that will govern their rights and obligations or those of possible adverse claimants with respect to securities that are pledged to them. Once the governing substantive law has been ascertained, financial market participants need to be certain that they have a distinct package of rights that cannot successfully be attacked by adverse claimants. One authority, Randall Guynn, has argued that "most national laws governing the ownership, transfer, and pledging of securities have become obsolete and should be modernized . . ."[123] He notes that most current laws do not allow investors or secured creditors to have this kind of certainty.[124] He takes the position that a set of national laws must be put in place

> that allows issuers, investors, and secured creditors to determine in advance—with certainty and predictability—the substantive law that will govern their rights and obligations and, perhaps most importantly, those of possible adverse claimants. It should also allow them to become certain that they have a distinct package of rights that cannot successfully be attacked by an adverse claimant once they have taken certain clearly defined and reasonable actions.[125]

In the United States, Revised Article 8 of the Code[126] is one such national law that provides certainty in this area. It has been enacted in several states in the United States and is pending for consideration in several others. Guynn has also found that there are two other national laws that could serve as models for reform in other countries: Belgian Royal Decree No. 62 dated November 10, 1967, Facilitating the Circulation of Securities (as amended April 7, 1995) and the Luxembourg Grand-Ducal Decrees of February 17, 1971, December 18, 1991, and June 8, 1994.[127] Guynn states:

> Perhaps the most important innovation of each of these laws is that they define a person's interest in securities held through any or certain types of financial intermediaries in terms other than traceable property rights in individual securities or mere contractual claims. Each defines such interests (with more or less clarity) as a property interest that is evidenced solely by an accounting entry on the books of the interest holder's intermediary and that does not include traceable property rights in individual securities. This innovation should promote the finality of transfers and pledges made by book entry to accounts with an intermediary and substantially increase the certainty and predictability of existing conflict of laws rules.[128]

Conclusion

Foreign exchange settlement risk can be reduced by the following three-track strategy.[129] First, individual banks can control their foreign

exchange settlement exposures by applying appropriate credit control processes. Second, industry groups can develop well-constructed multicurrency services that contribute to the risk-reduction efforts of individual banks. Third, central banks, in cooperation with the relevant supervisory authorities, can foster private sector action. The Group of Ten central banks recognize that cooperation between market participants and central banks is necessary to address the systemic risk inherent in current practices for settling foreign exchange transactions. In the Report, they endorse the three-track strategy.[130]

In conclusion, while perspectives of the risks and challenges may differ, the objectives of supervisors and market participants, as financial intermediaries and users of financial services, are the same, pointing toward maintaining a vibrant and strong financial system over the long term.

COMMENT

GARLAND D. SIMS AND ROBERT S. STEIGERWALD

Issues Regarding Payments and Netting Systems

The *Settlement Risk in Foreign Exchange Transactions* report (the Report)[1] prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries is a landmark in the history of the quest to reduce settlement risk. It is a summary of the studies and efforts to address the problem since the Bankhaus Herstatt collapsed in 1974 but, most importantly, it is a manifestation of the will and consensus of the central banks to take, or encourage, dramatic steps in the next two to three years that will make anything that has taken place in the past two decades look insignificant in comparison.

This is not to say that no significant progress was made in those two decades or that the Report does not represent the will of market participants as well. Indeed, the fact that more rapid progress is now possible is related to studies undertaken and developments achieved by industry groups, some with central bank participation and some independent. Thus, the Report signifies a general consensus that a partnership between central banks and market participants to develop a solution or solutions is necessary, although there are obviously many details to be worked out.

Although there are many different legal issues affecting payments and netting systems, the focus of this comment is on legal issues relating to the subject of the Report—reduction of settlement risk in foreign exchange transactions.

First, some basic terminology must be considered. Risk management professionals distinguish between "exposure" and "risk." By the former, they mean the amount that may be lost by a party to a transaction; by the latter, they mean the amount that may be lost times the probability that there will be a loss (loss being the actual amount of damages incurred). Obviously, it is easier to quantify exposure and loss than it is to quantify risk. In many contexts, the terms can be used interchangeably, especially when discussing legal issues. Nevertheless, it is helpful to adopt the distinction between the terms for present purposes where it appears to be appropriate.

Second, there are various ways to classify risks in connection with any transaction, foreign exchange or otherwise. The most fundamental would

be the distinction between noncredit risks and credit risks. Noncredit risks are risks that do not directly arise out of the possibility of counterparty default, such as market, liquidity, and operational risks. Credit risks, on the other hand, directly arise because of the possibility that a counterparty may default. In the case of foreign exchange transactions (as in the case of many other transactions traded in the financial markets), settlement risk is a type of credit risk along with replacement cost risk.

This comment uses the terminology used in the Report. Replacement cost risk is the risk that arises because a party (the "nondefaulting party") may have to replace foreign exchange transactions at more costly prices as the result of a default (often referred to by market participants as "mark-to-market risk");[2] settlement risk is the risk that a nondefaulting party will pay a defaulting party under a foreign exchange transaction and not be paid by the defaulting party (variously referred to as "principal," "notional," "delivery," and even "Herstatt" risk).[3] Replacement cost exposure for a particular foreign exchange exposure is constantly changing and is the incremental cost (which may be negative) to replace a transaction at current prices;[4] settlement exposure is constant (at least when considered in terms of a single transaction and the currency involved that is owed to the relevant party) and is the amount owed to the nondefaulting party under the relevant transaction.[5]

A further distinction to note between replacement cost risk and settlement risk is that replacement cost risk is more probable than settlement risk, although the exposure (the amount that may be lost) is smaller. Settlement exposure, on the other hand, is huge and is the reason for the various efforts considered herein, because such huge amounts are unacceptable even if it is believed that the probability of loss is smaller than in the case of replacement cost risk.

Furthermore, there are various collateral effects of settlement risk, which make it even more important that a solution be developed. First, a settlement loss may lead to gridlock in the international payments systems, usually referred to as "systemic risk." Second, the failure of a counterparty to deliver a currency may mean that the nondefaulting party must find sources to fund any obligation it has with other parties to deliver that currency (and this liquidity risk will exist even when a nondefaulting party has not incurred a settlement loss in connection with a defaulted transaction).

In considering settlement risk (and the related legal issues), it is appropriate to discuss the efforts to reduce such risk. Those efforts may be put in two major categories. First, there are the efforts that may be undertaken by individual banks on their own initiative. These are the various things listed in the Report,[6] including the recommendations of the New

York Foreign Exchange Committee's Summary of Recommendations for Private Sector Best Practices in Appendix 2 to the Report.[7] Examples include being more aware of settlement risk issues, taking steps to measure settlement risk adequately, shortening the period between dispatch of irrevocable payment instructions and reconciliation, and entering into netting arrangements with counterparties, to name a few.[8]

Second, there are mechanisms that depend on the joint efforts of industry groups and central banks. There are primarily two mechanisms—payment versus payment (PVP) and netting. If effectuated, true PVP can reduce settlement risk to zero. This is true whether or not payments under foreign exchange transactions are netted. Whether as a policy matter PVP alone or PVP with some kind of netting is desirable is a complicated issue that this comment does not attempt to answer. However, PVP of some sort must and will be achieved, perhaps in combination with netting. Also, in the short run at least, netting is a more achievable mechanism than PVP at the present time. In part, this is because the legal issues relating to netting have been more thoroughly researched in recent years; the legal issues involved in establishing a PVP system are just beginning to be investigated. However, PVP mostly depends on modifications to payment and settlement systems that are not yet in place and modifications that are not easy to achieve overnight.

For present purposes, therefore, this comment primarily concentrates on legal issues relating to netting. Of course, where appropriate, various issues relating to payments systems in general and PVP in particular are addressed, because netting and payments are obviously closely connected.

The terminology relating to netting is very imprecise. Often, for example, a client will call a lawyer and request the preparation of a netting agreement. Well, what kind of netting agreement is desired? A lawyer may be thinking in terms of a netting agreement that provides for termination of covered transactions in the event of default. It is interesting to note, however, that a foreign exchange salesperson or trader is usually not thinking in these terms. When such a person requests a netting agreement, he or she is thinking in terms of an agreement that nets payments under foreign exchange transactions having the same settlement date to one payment per currency. A credit officer, however, is probably thinking of something that combines the viewpoint of the lawyer and the salesperson—he or she wants an agreement that deals with both replacement cost exposure and settlement exposure.

Thus, some of the different types of netting need to be defined. The Report provides a useful set of definitions in Appendix 4.[9] First, there is obligation netting, which is "the legally binding netting of amounts due in the same currency for settlement on the same day under two or more

trades."[10] Obligation netting is mainly a mechanism that reduces settlement risk.

Obligation netting may be further subdivided. First, there is obligation netting where the individual transactions do not lose their identity at the time they are entered into. The essential nature of this type of netting is that net settlement takes place under the agreement but without any modification of the individual transactions having the same settlement date at the time a transaction with such a settlement date is entered into.

In the second type of obligation netting, the individual transactions at the time of the trade are canceled and simultaneously replaced by a new obligation in addition to net settlement. This is usually referred to as "novation," and the term in the Appendix 4 Glossary for this type of obligation netting is "netting by novation."[11] Note that, because it has the effect of legally modifying each contract when transactions with the same settlement date are entered into, netting by novation also reduces replacement cost risk. For this reason, it was first recognized by risk-based capital rules as the only type of netting that reduced replacement cost risk for capital purposes.[12]

Second, there is "closeout netting," which is "an arrangement to settle all contracted but not yet due liabilities to and claims on an institution by one single payment, immediately upon the occurrence of one of a list of defined events, such as the appointment of a liquidator to that institution. . . ."[13] Thus closeout netting is mainly a mechanism that reduces replacement cost risk.

Regardless of the type of obligation netting, it is important to note that it results in one payment per currency per settlement date. Unlike closeout netting, obligation netting affects day-to-day practice. Closeout netting is something that is put into an agreement, which is put on the shelf, and, hopefully, the closeout provisions are never used. Obligation-netting provisions, however, have a profound effect on practice every day. No doubt this is why an obligation-netting agreement is what clients of banks often have in mind when they call and ask that a netting agreement be prepared.

Some further types of netting should be mentioned to complete this typology. Netting, whether of the closeout or obligation-netting variety, can take place on either a branch-pair basis or on a multibranch basis. Practically, however, closeout netting usually is accomplished on a multibranch basis, which means that all transactions of all branches of an institution covered by the netting agreement are terminated, liquidated, and netted to determine a single amount in a base currency owed by one

party to the other. Operational issues make it difficult for many multibranch institutions to effectuate at this time obligation netting on a multibranch basis. Branch-pair netting, on the other hand, results in the netting of transactions between specific branches and is most characteristic of obligation netting.

Finally, netting of any type may be bilateral or multilateral. Bilateral netting is by far the more familiar in terms of actual practice, but multilateral netting will become more familiar in the near future. Until ECHO[14] started up in 1995, virtually all netting of foreign exchange transactions was done on a bilateral basis. It is important to point out, however, that both ECHO and Multinet International Bank[15] achieve multilateral netting by means of counterparty substitution. When such a clearinghouse matches a trade between two participants and it accepts the transactions, it becomes a party to each such transaction, standing in the middle between two equal and opposite transactions. In such situations, the relationship between the clearinghouse and each participant is a bilateral one, but the effect is multilateral because each participant has what is in effect a running account with the clearinghouse, resulting in one payment per currency per settlement date for all accepted transactions.

What can be done to advance the cause of settlement risk reduction? The Report provides a useful framework by dividing the efforts into three major categories: (i) individual bank steps; (ii) industry group developments and (iii) central bank initiatives and cooperation.[16]

Individual Bank Steps

In a way, individual bank steps are the most important, because they can be accomplished now. One of the problems industry groups face is the different agendas and priorities of their individual members. Of course, this is to some extent true within a single institution, but the scale is much different.

This comment primarily addresses legal issues that industry groups face, so it does not dwell on the myriad issues that are unique to individual bank steps. It is worth pointing out that one major step, entering into bilateral netting agreements with counterparties, has a well-founded legal basis largely as the result of efforts of industry groups. For example, as the result of efforts of industry groups located in the United States, Canada, England, Japan, and most other Group of Ten jurisdictions, there is a firm basis for the legal enforceability of industry standard netting agreements, such as the International Foreign Exchange Master Agreement,[17] the International Currency Options Market Master Agreement,[18] and the International Swaps and Derivatives Association

Master Agreement.[19] Counterparties in these jurisdictions are increasingly willing to document foreign exchange transactions under such master agreements. More needs to be done with counterparties in other jurisdictions, however.

Industry Group Developments

Industry groups developing multicurrency services face formidable obstacles of a practical and legal nature. This part outlines some of the most significant legal obstacles. There are three major categories for these issues—payments, netting, and collateral. Furthermore, for each category there are two fundamental, overarching issues for a multicurrency service—choice of law and finality.

Choice of Law

Choice of law in a way is the more fundamental of these two issues. Choice of law means determining the substantive law applicable under the conflict of laws rules of the relevant jurisdictions. Thus, choice of law actually is something broader than the law chosen by the parties in their documentation to govern their rights and obligations. Indeed, it is the question of whether that choice is valid under any of the systems of law that could conceivably be applicable to a multicurrency service. It may be more difficult to reach conclusions concerning choice of law than finality, because in many jurisdictions the answers depend on case law rather than a statute. In many instances, it may not be possible to come to a conclusion. Suffice it to say that if a clear answer cannot be reached as to choice of law, then the issue of finality must be investigated under the substantive laws of all jurisdictions that one reasonably concludes could be applicable.

The issue of choice of law has acquired acute importance in light of the global, cross-border nature of the foreign exchange market today. Unfortunately, the rules in most jurisdictions either are not clear or are not adequate for the situation. Many jurisdictions, including the United States, have choice of law rules that were adequate for the days when business was more likely to be confined within national borders.

Finality

In simple terms, finality involves the question of whether, when, and to what extent payments, netting, and security interests in collateral are enforceable. There are different levels of finality, however. Payments, for example, might be final as a matter of commercial or contract law, but might not be final if a party is subject to insolvency proceedings.

Insolvency finality might be achievable in certain jurisdictions, but might still be subject to residual uncertainties such as the possibility that governmental decrees, acts of state, or *force majeure* events may occur and affect enforceability. Thus, there are three broad levels of finality that one might seek to achieve: (i) contractual finality; (ii) insolvency finality; and (iii) absolute finality. This comment argues that absolute finality is not only unachievable at the present time, but that it is not even worthwhile to try to achieve absolute finality.

Payments

The Report defines finality in the context of payments (settlement) as payment that is irrevocable and unconditional.[20] A payment may be irrevocable in the sense that the sender cannot revoke it as a matter of contract law and the rules of the particular payment system, but may not be unconditional in the sense that the beneficiary has received a credit within the system that is enforceable both as a matter of the system's rules as well as in the event of the insolvency of the sender. For example, batch payment systems include a cutoff time for revoking payments but may not give unconditional credit to the recipient until the end of the day or even the end of the next day. In the case of real-time gross settlement (RTGS) systems, the point of irrevocability and unconditionality is theoretically the same, because the debit of the sender's account and the credit of the recipient's account occur in real time as the system receives and matches payment instructions rather than as a batch at the end of some stated period.

Payment systems that are not RTGS systems pose real problems for multicurrency services in terms of risk management, as well as liquidity and collateral needs. For example, under the rules of a particular system, a service might receive a payment that is irrevocable under the rules of the payment system relating to the currency of the payment, but that might not be unconditional until, for example, noon on the next business day. In other words, such a payment might be recalled if the sender went bankrupt before noon on the next day. Can the service make payment in the countercurrency or currencies to the sender on the day it receives the payment that is still conditional? What is its exposure in such circumstances?

If the service does pay the sender before the currency paid to the service becomes unconditional, it seems that it must measure its exposure in terms of (at least) two business days' risk. That will mean that the service has greater liquidity needs and that more collateral may be required from participants in the service, making it more expensive. Solutions can be worked out that shift the risk to an agent bank for the settlement cur-

rency, but those may pose difficult concentration of risk issues from a central bank policy perspective.

Netting

Netting, whether of the obligation-netting or closeout variety, should also be final. There has been a considerable amount of work in recent years to achieve finality at one level or another with respect to netting. Fundamental difficulties remain with respect to multilateral netting, however.

Bilateral netting (netting between two parties) is fairly well established in the Group of Ten countries. The Financial Markets Lawyers Group has obtained legal opinions on the International Foreign Exchange Master Agreement showing that obligation and closeout netting is enforceable in the event of insolvency of specific types of counterparties in all of the Group of Ten countries save one.[21] (This is not to say that the opinions do not have some important qualifications for particular circumstances.)

Jurisdictions that explicitly recognize multilateral netting, however, are in the minority. In the United States, for example, section 404(a) of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) provides that, "[n]otwithstanding any other provision of law," payments among members of a "clearing organization" are to be netted in accordance with the applicable netting agreement.[22]

True multilateral netting does not involve a clearing organization as a central counterparty. The Clearing House Interbank Payments System (CHIPS) is the best example we can think of in the United States. One net payment (U.S. dollars only) is owed by, or to, each member of the system on each day, reflecting netting of all the payment orders between members. This netting scheme is validated under section 404 of FDICIA.

In principle, true multilateral netting would be achievable for multicurrency services, at least under U.S. law. To be viable, however, a multicurrency service must include members in other jurisdictions where multilateral netting may not be enforceable. The solution that ECHO and Multinet International Bank have pursued is to become central counterparties to each trade. For example, the rules of Multinet International Bank provide that each transaction submitted by participants who have dealt with each other bilaterally is first submitted to various checks, including checks for compliance with exposure limits. If the transaction is matched and does not exceed the exposure limits, it is accepted by Multinet International Bank. That is, the transaction between the participants becomes subject to novation and Multinet International Bank is

substituted as a principal to each participant. The bilateral relationship between the two participants is replaced with a bilateral relationship between Multinet International Bank and each participant. Bilateral netting occurs between Multinet International Bank and each participant. However, because the bilateral relationship between Multinet International Bank and each participant will be affected by each transaction initiated by that participant with every other participant that is accepted by Multinet International Bank, multilateral risk (and cost) reductions are achieved.

In short, the mechanism of clearinghouse counterparty substitution achieves the risk-reduction benefits of multilateral netting, but involves a bilateral relationship between the clearinghouse and each participant. Such netting should be enforceable, therefore, in countries that recognize bilateral netting even if they do not recognize multilateral netting.

Another interesting issue is whether a multilateral system can accept transactions like those that have already been bilaterally netted, such as through the service provided by FXNET Ltd.[23] Such an arrangement may be preferable for certain participants because they have made significant investments in bilateral netting systems and do not wish to completely abandon them. They may feel more comfortable keeping their bilateral netting systems in place and just using a multilateral netting service to achieve further settlement risk reduction.

There have been rumors that some central banks do not like such netting, sometimes referred to as "netting on netting." Why this should be the case is not understandable, so long as the netting has a well-founded legal basis as required by the Lamfalussy standards.[24] In the United States, for example, the netting provisions of FDICIA[25] would uphold such netting among financial institutions under a netting agreement subject to U.S. law.

In a jurisdiction that does not have a netting statute such as FDICIA (which, incidentally, is not a bankruptcy statute but which overrides any bankruptcy statute because the netting provisions of FDICIA apply "notwithstanding any other provision of law")[26] there could be more concern about netting on netting if the statute in question does not validate netting per se, but validates it in the context of specified types of transactions. For example, the insolvency laws in the United States applicable to insured banks and corporate entities independently of FDICIA list various types of transactions, including foreign exchange transactions, for which contractual termination and setoff rights override any provision in the bankruptcy legislation to the contrary.[27] A lawyer might have some difficulty in concluding under such a statute that a bilaterally netted foreign exchange transaction (which is now just a series of cash flow rights and obligations) is a foreign exchange transaction under such a statute.

Fortunately, in the United States this is not an issue, because FDICIA, which governs any netting arrangement among financial institutions governed by U.S. law, is a statute that does not list particular types of transactions—it simply validates netting agreements. Furthermore, even without FDICIA the U.S. bankruptcy statutes noted above[28] list foreign exchange transactions but also validate closeout and setoff for any combination of such transactions.[29] It is submitted that it is the better view that such language cover cash flow rights and obligations that have already been bilaterally netted, as well as the original foreign exchange transactions.

For countries that do rely solely on a list of transactions, however, and do not have clear language applying to previously netted transactions, netting on netting could be an issue. Discussions with counsel whose opinions are being solicited by Multinet International Bank on this subject, however, reveal that most views are positive from the standpoint of legal enforceability. Some of the opinions may be quite reasoned—they are not based on clear case law or statutory precedent, but on what the writer believes to be the most rational conclusion. Thus, there is always some residual doubt. However, arguably, such a level of doubt is acceptable and should not mean that a multicurrency netting service does not have a well-founded legal basis.

Collateral

It will not do a multicurrency service any good to have finality of payment and finality of netting and yet be uncertain whether security interests granted to it are unenforceable. All the major services existing or proposed depend on liquidity facilities, largely on the basis of Lamfalussy Standard IV.[30] It is not enough that the system ensures that a participant that pays in does not lose the currency paid in; it must ensure that the participant gets the currency it expects notwithstanding the default of another participant. To ensure this, a service needs liquidity facilities, and liquidity providers will require collateral.

Unfortunately, far more work has been done advancing finality of payments and netting, especially in a cross-border context, than has been done with respect to finality of security interests in collateral. Much significant work is beginning to be done, however.

First, a framework for evaluating whether there is finality in the context of collateral should be considered. The most fundamental issue is whether the security interest has been validly created. In the United States, this is called "attachment," which essentially means that the party granting the security interest has rights in the collateral and has agreed to create the security interest, and that value has been given by the secured

party.[31] Attachment is necessary to enforce the security interest against the grantor. The next issue is whether the security interest is enforceable against third parties. This involves some steps taken that would be expected generally to give such parties notice that the security interest exists (possession, filing, etc.), and in the United States these steps are called "perfection."[32] Attachment and perfection are sufficient to achieve contractual finality. They are necessary for insolvency finality, but not sufficient. For insolvency finality, there is the question whether the collateral is immediately enforceable by the secured party or available, notwithstanding any bankruptcy stay, or preference, or similar rule that might otherwise apply.

In the United States, "transfers" (which term would include a grant of a security interest) in connection with specified transactions, such as foreign exchange transactions, are generally protected from the various bankruptcy rules that ordinarily would restrict action by, or create risks for, a creditor.[33] Nevertheless, not all types of insolvency proceedings include this protection, nor has this been found to be the rule in all other jurisdictions. The risks that a secured party faces when its counterparty is subject to insolvency proceedings fall in several categories that can be used generally to assess the insolvency laws of most countries.

First, there is "preference risk," which is the risk that a payment or grant of collateral made within a defined "suspect" period prior to insolvency will be required to be returned because the creditor has thereby received an advantage over other unsecured creditors.[34] The second risk is "constructive fraudulent conveyance risk," which is the risk that a payment or grant of collateral will be required to be returned on the ground, for example, that insufficient value was given to the insolvent party.[35] "Fraudulent conveyance" is the term used in the United States, and "constructive" means there has been no actual intent to defraud other creditors. By the way, under U.S. insolvency statutes, not even foreign exchange transactions are free from the risk that a payment, netting, or grant of collateral could be set aside because it is found that there has been actual intent to defraud creditors.[36] This is an example of why absolute finality is not achievable.

Furthermore, there is the risk that enforcement of a security interest will be stayed in the event of a bankruptcy proceeding ("stay risk")[37] and the risk that individual transactions will be selectively enforced ("cherry-picking risk").[38] The former is obviously a real problem for concluding that there is finality in the case of a security interest. The latter is more of an issue for closeout netting and, as noted above, has an effect on replacement cost risk but not settlement risk. Nevertheless, it could have a profound effect on the need for collateral, because it may mean that an

exposure that was assumed to be net is in fact a gross exposure, requiring more collateral.

The above framework, no doubt, does not include all the possible insolvency risks, which vary from jurisdiction to jurisdiction. It is a good start, however, for evaluating various insolvency regimes. In addition, the issues listed are an important basis for considering legislation to deal with these issues, which is addressed below.

Choice of law issues are especially acute when considering finality of security interests in collateral. If a multicurrency service headquartered in the United Kingdom has a security agreement governed by U.K. law and has U.S. dollar cash collateral from a German participant held in the United States, and the participant is subject to insolvency proceedings with respect to its branch in France, which law will apply? Will it make any difference whether the participant has a branch in the United States? This example may be unlikely, but it illustrates difficulties that are quite real.

Central Bank Initiatives and Cooperation

With all the uncertainties concerning choice of law and finality of payments, netting, and collateral, one may wonder whether multicurrency services are possible at all at the present time. Not only are they possible, but they are imperative. Now is the time to take bold steps.

Legislation

It is clear that many of the issues of finality require a legislative solution. It is often hard to make specific recommendations without considering the circumstances of a particular jurisdiction. Thus, generally, it is possible only to identify the issues that should be considered. The following are some suggestions for consideration to be included in legislation that could be sponsored by central banks in their individual jurisdictions.

- The legislation should adopt conflict of law rules recognizing the enforceability of the choice of law of the parties to a multicurrency service. Even if issues involving finality of payments, netting, and collateral are resolved satisfactorily for transactions taking place between participants within a particular country, there is often uncertainty in cross-border situations. The best rule is for legislation to recognize explicitly the choice of law of the parties to a multicurrency service, notwithstanding any apparent conflict of the chosen law with the general choice of law rules of the participant's country.

- The legislation should adopt clear rules regarding finality of payment in the country's payment system. The issue of finality of payment is even more fundamental than issues of netting because it is an issue of crucial importance to all multicurrency services, whether or not they involve netting. Payments in the jurisdictions of some countries may not be final until the end of the day or even until the next day. Absence of real-time finality can have significant collateral and liquidity ramifications for multicurrency services.
- The legislation should identify the basis for netting. Some netting statutes specifically require that an oral or written netting agreement be in effect. Legislation also might be based on a setoff approach that would apply whether or not there is a netting agreement. In any event, the basis should be clear.
- The legislation should clearly identify the types of entities to which it is applicable. A netting statute such as FDICIA in the United States clearly identifies the parties to which it is applicable. Amending bankruptcy statutes to recognize the enforceability of netting is another approach that is helpful, as long as the statute is clear as to which parties are covered. It should be clear at a minimum whether the legislation applies to the following types of entities: banks, savings institutions, trust companies and other types of depository institutions, broker-dealers and futures commission merchants, corporations, funds and other types of limited liability companies, partnerships, governments, municipalities, and quasi-public institutions.
- The legislation should clearly identify the types of transactions to which it applies. Perhaps the most essential feature of netting legislation is identification of the transactions covered. Typically, statutes have identified transactions by enumerating types. At a minimum, the following categories should be considered: foreign exchange transactions; swaps (including rate swaps, basis swaps, forward rate transactions, commodity swaps, equity or equity linked swaps, and currency and cross-currency rate swaps); swap-related derivatives (including cap, floor, and collar transactions); securities transactions; commodities transactions; options (including bond options, equity or equity index options, interest rate options, and currency options); and options on any of the foregoing. Another approach is just to stipulate (as does FDICIA in the United States) that agreements providing for net payments (including as the result of closeout) are enforceable.[39]
- The legislation should explicitly extend netting benefits to spot as well as forward transactions. Spot transactions include any transac-

tion with a maturity of two days or less. Some netting statutes have failed to include spot transactions explicitly, resulting in uncertainty as to the enforceability of agreements that cover both spot and forward transactions. There is no valid reason for distinguishing between spot and forward transactions for the purposes of netting. Furthermore, since netting agreements typically cover both types of transactions, it is essential to make it clear that both types of transactions are entitled to netting benefits.

- The legislation should make it clear that it applies to "master-master" and cross-product netting agreements. The enforceability of netting agreements applying to more than one type of transaction or product has been a major issue in some jurisdictions.

- The legislation should make it clear that covered transactions are not unenforceable under laws prohibiting gambling. Some jurisdictions have statutes that prohibit gambling or "gaming." Such laws should not be applicable to transactions with a commercial purpose, such as those subject to netting legislation.

- The legislation should identify the types of netting that are covered. As identified in the Report, there are several distinct types of netting.[40] Netting legislation should be as broad as possible covering at a minimum obligation netting and closeout netting, whether conducted on a bilateral or multilateral basis. In addition, there are variations and hybrids of the foregoing that should be covered (for example, multibranch bilateral netting and multilateral netting achieved through bilateral counterparty substitution).

- The legislation should make it clear that it applies to previously netted transactions. A statute may apply to foreign exchange transactions, for example, and those transactions may be subject to obligation netting on a single settlement date, as noted in the above point. The legislation should make it clear that such resulting netted transactions may be validly netted, such as would occur in the case of closeout netting of previously netted transactions.

- The legislation should, at a minimum, explicitly eliminate or explain the effect on netting of the following insolvency risks: (i) preference risk, (ii) constructive fraudulent conveyance risk, (iii) stay risk, and (iv) cherry-picking risk. Preference risk is the risk that a payment or delivery (or grant of collateral) made prior to insolvency will be required to be returned because a particular creditor is preferred over others.[41] Constructive fraudulent conveyance risk is the risk that a payment or delivery (or grant of collateral) will be required to be returned on the ground, for example, that insufficient consider-

ation was obtained.[42] (Some jurisdictions may want to preserve the right to avoid transfers where there is something more, such as an actual intent to defraud creditors.) Stay risk is the risk that insolvency procedures will prevent the nondefaulting party from exercising its rights to terminate and liquidate transactions with the defaulting party.[43] Cherry-picking risk is the risk that the defaulting party will be permitted to enforce transactions selectively, that is, transactions that are to its advantage, while rejecting performance of transactions that are not to its advantage.[44]

- The legislation should make it clear that optional termination is enforceable after the commencement of insolvency proceedings. One of the aspects of stay risk, as noted in the above point, is that optional termination may not be enforceable after the commencement of insolvency proceedings. This leads some parties to choose automatic termination upon, or immediately prior to, the commencement of such proceedings in order to avoid this risk. Automatic termination is less desirable because the nondefaulting party may not learn of the termination until some time after the event, thus forcing the liquidation of transactions at prices that may not make the nondefaulting party whole.
- The legislation should clearly indicate whether global netting is recognized. It is highly desirable from the point of view of the parties' expectations that the entire netting agreement of the parties be enforced in the home jurisdiction of the defaulting party, regardless of the effectiveness of netting in other jurisdictions in which other branches or offices of the defaulting party may be located. In addition, it is highly desirable that the jurisdiction clearly indicate how master agreements covering branches of entities located in the jurisdiction, but not domiciled there, will be treated in the event of insolvency.
- The legislation should adopt clear rules concerning enforceability of security interests. Certainty as to the enforceability of security interests within a jurisdiction is essential for the operation of a multicurrency service. This includes certainty that the security interests would be immediately enforceable upon default, including in bankruptcy. Obviously, security interests in accounts denominated in a country's currency and securities held through a financial intermediary in that country are the most likely to be involved in a multicurrency service. Choice of law rules that validate the parties' choice of law, notwithstanding location of the collateral, are desirable.
- The legislation should make it clear that electronic communications are sufficient for the enforceability of individual transactions. Some

jurisdictions have a requirement (such as statute of frauds laws in the United States)[45] that agreements be in writing. No matter how such a requirement applies to a master agreement that has netting provisions and other terms, in light of modern practice, it should not require signed documents if the transactions are evidenced by electronic means, such as recorded telephone conversations or electronic dealing systems.

Other Steps

Although legislation may provide the most certainty, practical difficulties may need to be addressed as well. There are many things that central banks can do to stimulate industry group developments and cooperate with them short of sponsoring legislation. Explicit encouragement of industry group efforts is essential. The Report is a giant step in this direction. More needs to be done within countries so that concrete steps are taken by market participants. In addition, the central bank may wish to sponsor groups of lawyers who practice in the field of financial markets law. Such lawyer groups are not industry groups, but they are helpful forums to discover and discuss issues and propose solutions that affect industry group efforts. The inclination of some to sit back and let others do the developmental work needs to be addressed. The benefits of the initiatives discussed in this comment are real and substantial, but they will only become truly viable with the participation of most of those who stand to benefit.

Central banks need to be sympathetic to the problems that industry groups face in developing multicurrency services. In this comment, some of the legal issues have been addressed. However, legal issues are only part of the picture. Industry groups are made up of members that do not all have the same goals and interests. There are the issues of cost and time, and enormous practical problems arise in forming such a service—such as structuring the organization, developing documentation, getting regulatory approvals, developing systems and operations, and obtaining personnel and facilities—all for a venture that will not directly enhance revenues.

Such "sympathy" is only useful in concrete forms. For example, central banks should understand the need to control costs. The best solution is one that achieves the proper balance between costs and benefits. This, of course, is more of an art than a science.

Central banks must also accept less-than-absolute certainty with respect to the resolution of the legal issues that arise. This is especially so because of the multinational character of the undertaking to reduce settlement risk. A well-founded basis does not mean that there can be no

legal risks. As long as the risks are sufficiently remote or a reasonable basis exists for identifying exposures, controlling responsibility for any identifiable loss and controlling the magnitude of the risks pose acceptable partial solutions.

Finally, central banks can expedite the approval process. This is not to say that central banks should be reckless. However, where they have regulatory discretion to do so, breaking down the barriers of red tape is a key ingredient in success. An effort to build a multicurrency service is a unique undertaking. Such a fact is an argument for caution. Still, there are no doubt many issues in the regulatory approval process that may technically apply but that are irrelevant in light of what people are trying to achieve.

Hypotheticals

The following are some hypothetical situations that illustrate some of the issues in this comment. The first hypothetical considers some individual bank steps that might be taken by a typical money center bank. The second hypothetical considers some industry group efforts in which such a bank might participate. Following the hypotheticals is an analysis of each.

Hypothetical Number 1: Individual Bank Steps

A new credit officer of First National Bank has been hired, and in her first week she tries to familiarize herself with the new environment. Having been very concerned by the issue of settlement risk at her former employer, she decides first to investigate how settlement risk is measured at First National Bank.

She finds that settlement exposure is measured by the amount due from a counterparty to First National Bank in all currencies (converted at current rates into U.S. dollars) on a single day. She questions whether any thought has been given to measuring the exposure in terms of more than one business day, in light of the fact that there is likely to be more than one day's risk between irrevocability of First National's payment instructions and reconcilement, as noted in a report by the Foreign Exchange Committee of the Federal Reserve Bank of New York, entitled *Reducing Foreign Exchange Settlement Risk*.[46] Those listening to her inquiries are puzzled by her question. Their response: "This is the way we have always done it." The credit officer asks whether it makes any difference in the measurement of settlement exposure if receipts by First National Bank in a particular currency are not final until the next business day. Again, the response is negative.

Resolving to discuss the matter of the measurement of settlement exposure further, the credit officer decides to inquire into netting arrangements with various counterparties. She finds from her credit coordination staff that there is a very firm rule about requiring netting agreements and supporting legal opinions in order to measure replacement cost exposure on a net basis, but she finds that there is no such requirement in the case of settlement exposure.

Based on her knowledge of bankruptcy law, the credit officer believes that there are lots of things that can happen in countries where netting is not enforceable in the event of the insolvency of the counterparty. Under the laws of country X (indeed of any country potentially), enforcement of a netting agreement could be stayed; individual contracts subject to the netting agreement could be selectively enforced (cherry-picked); and payments received during a suspect period prior to insolvency could be required to be returned as preferential. The member of the credit coordination staff says that he has thought about this quite thoroughly, and, whereas the credit officer is right with respect to replacement cost exposure, which he believes is the only type of exposure affected by cherry-picking and the other damages mentioned, he does not believe that settlement exposure should be affected. After all, if First National and the counterparty have an obligation netting agreement and actually are netting, how important is it that there be a legal opinion? "Would a court that permits cherry-picking also require us to pay on a gross basis and not get paid by the counterparty?"

Concerned by the discoveries that she has made with respect to payments and netting, the credit officer turns her attention to collateral. She wants to know how First National measures exposure when it is secured by collateral. She finds that exposure is reduced to the extent that there is cash collateral or liquid government securities. There are firm opinions in the files that the collateral is perfected in the jurisdictions where the collateral is located (the location of the branch of First National at which the cash or securities are held). The credit officer is relieved. At least in this matter, the basis for measuring credit risk seems to be based on solid ground. Her beliefs are shattered, however, when she tests her conclusions with a lawyer in First National's legal department.

Hypothetical Number 2: Industry Group Developments

First National Bank's credit officer has received a telephone call from a marketing representative of a proposed foreign exchange clearinghouse. The representative has thoroughly explained all the risk-reduction benefits of the proposed clearinghouse and has pointed out that, since the clearinghouse is still in the development stage, First National Bank has

the option to become a shareholder in the clearinghouse at this time as well as a participant in (that is, user of) the clearinghouse's services when it commences business. The credit officer meets with the business executive for the foreign exchange trading business of First National Bank and the two discuss the benefits and costs.

The credit officer points out that there are significant reductions in replacement cost exposure with the institutions that are currently planning to participate in the proposed clearinghouse, and there is an especially significant reduction in settlement exposure even when compared to exposures that have already been bilaterally netted. The two offices defer valuing this exposure, however, for the present. There will be fewer payments for the foreign exchange department to make, and this certainly can be quantified (the two offices note that they should consult with the payments department about this, however, the department will be impacted negatively by a reduction in payments by its customers who are in the netting system).

On the cost side, the two offices first note the cost of collateral. That cost can be quantified, as can the cost of the system changes to hook up to the clearinghouse's system. If First National Bank became a shareholder, there would be the cost of the equity investment. The two offices briefly discuss this possibility. The credit officer points out that the advantage would be an opportunity to participate in the structuring and governance of the clearinghouse. The business executive notes that there are several competing industry groups vying for their attention; if First National Bank joins now, there would be significant costs in terms of hours, travel, and so on without certainty that there would ever be a functioning service.

After this discussion, the credit officer decides to get some input from the legal department about the enforceability of multilateral netting. The lawyer she meets points out that there are many issues to consider. First, there is the basic question of whether multilateral netting is enforceable. Bilateral netting is generally enforceable in most of the Group of Ten countries, but he believes the situation may be otherwise in the case of multilateral netting. Second, he understands from the credit officer's presentation that the clearinghouse intends to accept for multilateral netting trades that have already been netted under a bilateral netting service. The lawyer believes that there are problems with such a proposal, referred to as "netting on netting." Furthermore, there are difficult issues concerning finality of payments, enforceability of security interests given to the clearinghouse and to liquidity providers, and choice of law rules of the clearinghouses's jurisdiction involving cross-border situations. He emphasizes that it is impossible to resolve these issues with absolute cer-

tainty, considering the present state of the law, and this may not constitute a well-founded legal basis under the Lamfalussy standards.[47]

As a result of these discussions, the credit officer decides that it is best to let the industry groups bring further proof. There are too many practical and legal uncertainties. Let others bear the burden and cost of organizing the proposed clearinghouse. If it gets started, First National Bank could then join as a participant. Of course, even if the practical and legal issues are resolved and the clearinghouse does begin operations, there is some uncertainty in her mind as to whether First National Bank would even join as a participant. Despite the clear benefits of settlement exposure reduction in terms of sheer numbers, she has been unable to make a business case for joining the clearinghouse, because she feels it is impossible to quantify the value of the reduction in settlement risk.

Analysis

Hypothetical Number 1: Individual Bank Steps

The credit officer is right to question whether it is accurate to measure settlement risk in terms of one day's exposure. In *Reducing Foreign Exchange Settlement Risk,* the Foreign Exchange Committee argues persuasively that settlement risk exists from the point that a party's instructions to make payment of its obligation under a foreign exchange transaction becomes irrevocable until the point at which the party reconciles its records to determine that it actually has received payment of what it is owed under the transaction.[48] Since typically payment instructions become irrevocable at least one day prior to settlement and reconciliation does not take place until one day after settlement, this means that there is exposure for at least three days for any one transaction, and longer periods are possible. To this must be added the exposure for any other transactions during such period for which an irrevocable payment order has gone out or for which reconciliation has not taken place. Furthermore, the absence of finality for payments received can further increase exposure.

Having opinions establishing sufficient certainty that netting agreements are enforceable is good practice for calculating exposure as net for credit purposes. It is also a requirement for counting exposure as net for regulatory capital purposes in the United States. Opinions from most major countries as to the enforceability of master agreements such as the IFEMA[49] have been obtained by industry groups such as the Financial Markets Lawyers Group in the United States.[50]

There is an argument that agreements providing for settlement netting (as opposed to replacement cost netting) do not need to be legally enforceable in order to justify counting settlement exposure on a net

basis for credit purposes. For example, even if netting agreements are not enforceable in a particular jurisdiction, if a bank has a settlement netting agreement with a customer in that jurisdiction and is settling transactions under the agreement on a net basis, it is hard to see how the bank could be legally required to settle a transaction on a gross basis upon the counterparty's insolvency unless the counterparty also performed under the transaction on a gross basis. In such a case, there would be no settlement exposure by definition. (There is only settlement risk if the counterparty does not perform.) It is theoretically possible that the insolvency law of a jurisdiction would require the bank to perform on a gross basis without requiring the counterparty to perform, although this would seem to be extremely unlikely. Nevertheless, while there is a theoretical argument that the agreement need not be enforceable to have a net settlement exposure as a practical matter, it is good practice to understand the legal implications of one's contracts and to avoid reliance on agreements that are not likely to be enforceable. Furthermore, the issue is mooted in many jurisdictions by the fact that there are now quite a few legal opinions available (such as those obtained by the Financial Markets Lawyers Group)[51] that verify the enforceability of settlement netting as well as closeout netting under master agreements such as the IFEMA.

It is generally not sufficient to have opinions on the enforceability of security interests in collateral in only the jurisdictions where the collateral is located. A security interest may be enforceable in the jurisdiction where the collateral is located, for example, but may not be enforceable in the jurisdiction where the counterparty is located. In such a case, there would be a question whether the jurisdiction where the collateral is located would recognize, or give comity, to the law of the jurisdiction where the counterparty is located. Even if the jurisdiction where the collateral is located would not give comity to the counterparty's law, there may be troubling consequences for the secured party if it has any presence in the counterparty's jurisdiction.

Hypothetical Number 2: Industry Group Developments

It may be difficult to do the cost-benefit analysis for joining a multicurrency service, but it is a question that must be considered by every institution that is considering participation in such a service. The costs are fairly easy to calculate: there is the cost of collateral, of modifying systems or installing new ones, and, of course, the pricing of the service itself. As for the benefits, there are the reduced costs for settlements and, the most significant benefit, the reduction in risk. Just for settlement risk alone, the reduction is tremendous, especially when looked at from the viewpoint of reduction in the dollar value of transactions, which in the case of multi-

lateral netting can go from 50 percent for netting on a bilateral basis to 80 percent to 90 percent when netting on a multilateral basis.

Because, as was argued in this comment, exposure is not risk, there is really no way to quantify precisely the value of such risk reduction. Most institutions make a somewhat subjective judgment when considering this question—they feel either that the numbers make participating in a multicurrency service worth it, or they do not. Each institution must make its own decision.

Many, if not most, institutions have concluded that something has to be done about the current levels of settlement risk and that participating in a multicurrency service will be desirable when available. It is unfortunate, however, that most such institutions believe that it is acceptable to let a few institutions do all the work in developing such a service. Such institutions are forfeiting an excellent opportunity to participate in the development of the service and to have an input into its structuring so that it best reflects the needs of the widest range of possible participants.

The legal issues arising in connection with a multicurrency service are formidable, but this should not be a reason not to participate. Much has already been learned that gives reasonable assurance that multilateral netting will work in most jurisdictions if structured so that the central clearinghouse is substituted as a counterparty for all accepted transactions. In such a model, the netting between the clearinghouse and each participant is on a bilateral basis (although the effect is multilateral), because each participant will have a bilateral relationship with the clearinghouse in respect of all accepted trades of that participant with all participants in the clearinghouse. Since bilateral netting has a well-founded legal basis in most Group of Ten countries, this method of achieving multilateral netting also should have a well-founded legal basis.

Netting on netting does not appear to be an issue for jurisdictions such as the United States (where netting is recognized under FDICIA)[52] and the United Kingdom (where netting is recognized under the insolvency laws as an aspect of the law of setoff).[53] Further research needs to be done, but this should not be a cause for nonparticipation.

There is also evidence that security interests in cross-border contexts will be enforceable with a reasonable degree of certainty in most Group of Ten countries notwithstanding some residual uncertainties regarding choice of law. After all, ECHO has already commenced business where such issues are a practical reality, and Multinet International Bank is expected to commence business in 1997.[54] Such multicurrency services would not be possible unless cross-border issues regarding collateral were not resolved with a sufficient degree of comfort under the Lamfalussy standards.[55]

Chapter 5

Cross-Border Electronic Banking: Perspectives on Systemic Risk and Sovereignty

RAJ BHALA[1]

Two Macrolevel Challenges

The interaction between electronic technology and international banking raises macrolevel challenges that involve a complex mix of finance, law, and policy. This chapter focuses on two broad classes of challenges: systemic risk and sovereignty.[2] The first challenge is whether cross-border electronic banking has rendered the international banking system inherently more volatile. Are international banking transactions inherently more risky now than, for example, 20 years ago? In other words, this challenge raises a fundamental systemic public policy concern: To what extent do cross-border electronic banking transactions exacerbate systemic risk?

The second challenge is whether cross-border electronic banking has eroded the sovereign autonomy of central banks to conduct their own banking policies. Are central banks now captive to a technologically driven system? No member of the international banking community doubts that it is the responsibility of each government to safeguard its banking system. Even Adam Smith, in *The Wealth of Nations*, would appear to accept financial system regulation as a legitimate function of government.[3] Of course, Smith could not have anticipated electronic foreign exchange trading, electronic data interchange (EDI), or the Internet. Never before has the difficulty of central banks to keep pace with change been so obvious. This difficulty raises another significant public policy concern, What is the appropriate role of a central bank that finds itself perpetually "behind the curve" of developments?[4] Should it, for example, promote market-based self-regulation?

This chapter addresses, in a preliminary fashion, the systemic risk and sovereignty challenges posed by cross-border electronic banking. First, the meaning of "cross-border electronic banking" is explained. Second, cross-border electronic banking and systemic risk are addressed. The chapter argues that electronic technology is both part of the problem and part of the solution. The third part of this paper focuses on the impact of cross-border electronic banking on sovereignty. It maintains that elec-

tronic technology has indeed undermined the autonomy of central banks. The last part sets forth conclusions.

Defining the Terms: What Is Cross-Border Electronic Banking?

Bank use of computer and other electronic technologies is a dramatic development in how banks do business. All of the transactional, legal, and policy implications of this use are not yet clear. The following two parts of this chapter address some of the key implications, but to understand them it is first necessary to agree upon a definition of cross-border electronic banking.

Cross Border

The term "cross border" is not problematical. It simply conveys the notion of transcending a geopolitical boundary that divides two or more countries. The challenge is to construct a definition of "electronic banking" that accurately encompasses the dizzying array of contemporary technologies used by banks.

Electronic Banking: Financial and Commercial Purposes

A starting point is to classify the variety of purposes for which banks use electronic technology. Two broad categories exist: financial and commercial. The financial category pertains to the trading, on a principal or agency basis, of financial instruments. For example, banks use electronic technology to trade in the foreign exchange and securities markets. The following two parts of this chapter focus on the financial category. Nonetheless, the commercial category is equally significant. The commercial category pertains to trading goods, that is, physical commodities from mangoes to microprocessor chips. Banks use electronic technology to facilitate their roles in commercial transactions. For instance, they use it to transfer funds by wire and transmit shipping documents, such as bills of lading.[5]

Three features of electronic technology make it possible for banks to use this technology in financial and commercial transactions. First, the technology offers banks the ability to conduct transactions with great speed. For instance, through an electronic direct dealing system, the terms of a spot or forward foreign exchange trade can be negotiated and agreed in seconds. In part, increased transactional speed results from the elimination of paper. Consider the settlement of a spot or forward foreign exchange transaction. Assume, as is usually the case, that the currencies in a spot or forward foreign exchange transaction are delivered through

a real-time gross settlement (RTGS) payments system. In such a case, the appropriate amounts of bank credit denominated in the relevant currencies are transferred in seconds. In other words, neither is physical currency delivered nor are paper-based negotiable instruments exchanged. Rather, bank credit is swapped.[6]

Second, electronic technology allows banks to store, transmit, reproduce, access, integrate, and manipulate voluminous amounts of information. For example, through an electronic direct dealing system, counterparties to a spot or forward foreign exchange trade can exchange all contractual terms and settlement instructions. Again, the elimination of paper makes it easier to handle large databases.

Third, the technology reduces bank operating costs. Once again, this positive feature results in part from the elimination of paper. Indeed, studies indicate that cost savings range from $5–$50 a document.[7]

Electronic Banking

Electronic banking involves the dematerialization of banking transactions.[8] Data in paperless form are exchanged. Accordingly, electronic banking may be defined as the computer-to-computer exchange of information or value in a predetermined format.[9] Actually, this definition applies to a concept even broader than electronic banking, namely, EDI. Electronic banking may be thought of as EDI involving banks.

There are two key parts to the definition. First, the definition suggests a network of two or more computers linked together. Typically, the linkage makes use of telecommunications lines. Interestingly, in 1995 for the first time, data transmitted via the world's telecommunications lines exceeded voice traffic over such lines.[10] In other words, telecommunications systems are now used more for data exchange than telephone calls. As a result of this linkage, the computers "talk" directly to one another, as in the electronic direct dealing example above.

Second, the definition of electronic banking indicates that the data exchanged by the computers appear in a preset format. This format can be recognized by the computers and their bank users. In turn, the format is based on a software program tailor-made for a particular use, such as trading currency spots and forwards.

Of course, in thinking of electronic banking as EDI involving banks, an important caveat should be remembered. As the definition suggests, electronic banking involves the computer-to-computer exchange of information or value. The settling of a foreign exchange trade through an RTGS system illustrates the importance of the latter. In an RTGS system, such as Fedwire, a payment order is not merely information, but is also value.

It represents the transfer of bank credit from one account to another by computer. Simply, in an RTGS system, the message is the money,[11] and the definition of electronic banking needs to accommodate this fact.

Systemic Risk

Cross-Border Electronic Banking as Part of the Problem

Recent crises create the impression that cross-border electronic banking makes the international banking system inherently riskier than before. More potentially serious problems occurred between 1991–95 than in the previous years of the post–World War II period.

Making Matters Worse?

In 1991, the Bank of Credit and Commerce International (BCCI) collapsed. In 1992–93, the Bank of England was forced to suspend the participation of the pound sterling in the European exchange rate mechanism. In 1994–95, the Mexican peso crisis and the subsequent "tequila effect" occurred. In 1995, Barings collapsed and Daiwa's treasury loss scandal unfolded. In contrast, between the end of World War II and 1991, there were two key events of such magnitude: the death of the gold standard in 1971 and the Third World debt crisis of the 1970s. To be sure, 1991 is not the year the computer revolution began, and the 1991–95 calamities cannot be blamed solely on cross-border electronic banking. However, computing power and speed have accelerated in the 1990s, and there appears to be a widely held view that such power and speed "make matters worse."

For example, cross-border electronic banking seems to increase the potential scope of a crisis. Every day, this technology is used to process $2.8 trillion worth of funds transfers in the computers of the Federal Reserve Bank of New York and to support over $1 trillion of turnover in the foreign exchange markets.[12] In contrast, a "big" day on the New York Stock Exchange is $14 billion. Also, by way of contrast, the total value of world trade of goods and services in 1995 was approximately $6 trillion.[13] Thus, roughly every two days the value of world trade goes through Federal Reserve computers, and about every week that value is transacted electronically in currency markets. In brief, electronic technology facilitates increases in the magnitude and speed of banking transactions. Moreover, electronic technology increases linkages among markets. For instance, dollars transacted in the currency markets are delivered through the New York Clearing House Interbank Payments System (CHIPS) or Fedwire. Hence, the currency markets are integrally linked with the payment system.[14]

Systemic Risk and Its Components

Is the popular belief that cross-border electronic banking makes matters worse correct? An affirmative answer is in order. Cross-border electronic banking has fundamentally and irreversibly altered perceptions of systemic risk. Systemic risk is conventionally defined as the risk that the failure of one bank will cause failures of that bank's counterparties, that is, create a domino effect. However, this definition is incomplete in two respects. First, bank failures have implications for the real economy. Systemic risk should be thought of as the risk that a disruption in the financial system, of whatever origin, will cause not only multiple bank failures but also a disruption in the real economy.

Second, the conventional definition glosses over the components of systemic risk. There are six such components:

- credit risk, which is the risk of counterparty default (for example, the 1974 failure of the German Bankhaus Herstatt to deliver currency in a foreign exchange transaction);
- market risk, which is the risk of a substantial decline in the value of a group of assets that forces a bank to absorb a serious loss (for example, in consequence of the 1987 U.S. stock market crash);
- market liquidity risk, which is the risk that liquidity in a market or group of markets evaporates so that a bank cannot sell its positions without incurring serious losses (for example, the inability of a bank to sell an exotic derivative);
- payments or settlement risk, which is the risk of a disruption or failure in a payment or settlement transaction (for example, delivering funds or securities or in an entire payment or settlement system, for example, CHIPS or Euroclear);[15]
- operational risk, which is the risk that a bank's computer system will go down (for example, the 1985 failure of the Bank of New York's computer system for delivering government securities);[16] and
- legal risk, which is the risk that an outstanding transaction does not fit within the law (for example, the English *Hammersmith* case in which it was held that a U.K. local governmental authority lacked legal authority to enter into swap contracts).[17]

During an international banking crisis, these six types of risk may coexist and "melt together." Moreover, they may materialize not only in the Group of Ten countries but also in increasingly important trading centers such as Hong Kong, Singapore, and Kuala Lumpur. There are perhaps 20–30 countries important enough in the international banking system

so that a disruption in any one of them could create systemic risk difficulties throughout the world.

Implications for Market Liquidity Risk, Settlement Risk, and Operational Risk

Cross-border electronic banking has especially significant implications for three of the components of systemic risk: market liquidity risk, payments and settlement risk, and operational risk. With respect to each component, electronic technology creates a false sense of comfort based on its ostensible invincibility. Consider market liquidity risk. Electronic technology causes every bank to believe that the bank can be "the first one out the door" to sell assets when necessary. This belief creates the illusion that every market is sufficiently liquid to support rapid sales of large volumes. In fact, liquidity depends on the number of ready, willing, and able buyers, not on the mere technological ability to sell.

Similarly, banks may understate settlement risk because of faith in the power of electronic clearing and settlement systems. Recall the many preparations that CHIPS takes against settlement failures, from posting additional collateral, to guaranteeing receiver finality, to conducting periodic stress and casualty tests. These precautions, which are essential, help create an aura that CHIPS will not fail to settle, that is, that the unwind scenario contemplated in the United Nations Model Law on International Credit Transfers[18] and Uniform Commercial Code Article 4A on Funds Transfers[19] will not occur.[20] Yet, like nuclear war, the consequences of this very low probability event could be devastating. Consider what might have happened if Barings had not fulfilled its obligation to pay roughly $850 million in margin payments to the Singapore Monetary Exchange (SIMEX) or to the Tokyo Stock Exchange (TSE) after its Nikkei stock index futures losses were disclosed. Might SIMEX and the TSE have gone insolvent? The same issue arose with respect to the Options Clearing Corporation after the 1987 U.S. stock market crash.

Operational risks associated with cross-border electronic banking may increase in proportion with the sophistication of that technology. The more moving parts in a mechanism, the more opportunities for a part to break. Likewise, the greater the number of lines in a computer program, the higher the chance of a "bug" or "glitch." It only took one glitch in 1985 to prevent the Bank of New York's computers from properly executing government securities transactions. That glitch led to the record $23 billion loan, made at 2:15 a.m. from the discount window of the Federal Reserve Bank of New York.[21] Yet, as with market liquidity and settlement risk, there may be an unrealistically low appreciation of operational risk in the international banking system.

Cross-Border Electronic Banking as Part of the Solution

While electronic technology distorts perceptions about market liquidity, settlement, and operational risk, it is also a key to a safer, sounder international banking system. It offers the prospect of more accurate monitoring of market risk and perhaps even reductions of this component of systemic risk. Indeed, any internationally active bank must develop state-of-the-art risk-management systems to measure market risk. It must, for example, monitor all of its transactions in real time and compute financial instrument values each day on a mark-to-market basis. For instruments that have no market, such as exotic derivatives, the bank must have realistic valuation models.

Private Risk-Management Systems

Risk-management systems are made possible by electronic technology. The key question that every bank must answer is, What is the maximum loss that the bank can reasonably expect to incur from its portfolio of financial instruments? The only way to answer this question is through a sophisticated computer model that measures the amount of earnings or capital that a bank stands to lose as a result of each of its transactions, that is, a value-at-risk (VAR) model. J.P. Morgan's RiskMetrics computer software is an example. J.P. Morgan freely distributes this software on diskette along with a brief summary and detailed technical booklet. A bank can modify the standard VAR model to suit its needs.

Fortunately, the Basle Committee on Banking Supervision (commonly known as the Basle Supervisors Committee) recognizes the importance of risk-management systems devised by financial services firms such as J.P. Morgan. In January 1996, the Basle Supervisors Committee published a market risk capital adequacy amendment to the 1988 Basle Capital Accord.[22] This amendment allows banks to calculate the amount of capital that they must maintain to absorb losses arising from market risk by following a standard methodology devised by the Basle Supervisors Committee. Alternatively, banks can adhere to their own risk-management methodology, as long as it meets certain qualitative and quantitative standards devised by the Basle Committee. The qualitative and quantitative standards help to ensure that a bank-designed risk-management methodology is flexible enough to allow a bank to function profitably and rigorous enough to prevent the bank from operating in an unsafe and unsound manner.

For the first time in the history of international banking law, the Basle Supervisors Committee has granted banks the ability to self-regulate: the Committee accepts the validity of computer models designed and implemented by banks for the purpose of calculating regulatory capital. In effect,

the Committee has been forced to acknowledge two realities. First, central banks cannot rely on physical books and records to measure market risk. Second, practicing commercial bankers, not bank regulators, are in a better position than regulators to devise computer-driven risk-measurement systems.[23]

In sum, improved private market risk-management systems may help reduce the perception that cross-border electronic banking "makes matters worse." Further, such systems might lead to more accurate perceptions of market liquidity, settlement, and operational risk. In other words, electronic technology already is part of the solution with respect to market risk, and soon it could help reduce other components of systemic risk.

Nontechnological Answers

Of course, electronic technology, such as the VAR model, is a necessary but not sufficient answer to problems associated with cross-border electronic banking. As a March 1995 report of the Derivatives Policy Group (DPG) correctly points out, internationally active banks ought to disclose fully to regulators the risks incurred from financial transactions.[24] Moreover, the DPG report calls upon banks to develop state-of-the-art management controls.[25] For instance, the trading and price verification functions of a bank must be entirely autonomous. Senior bank management must take a hands-on approach to understanding what is happening on all of the bank's trading floors around the world. It is unacceptable to allow a trader in Singapore to "dance to his own tune." The lack of disclosure, separate functions, and senior management involvement were contributing factors in the Barings and Daiwa affairs; in both cases, disclosures were not made to regulators, and a "rogue" trader or traders were responsible for pricing financial instruments.

To be sure, it is expensive for a bank to maintain a rigorous regulatory disclosure system, and separate trading and pricing functions. Accordingly, it is possible that in the next five to ten years there will be a substantial decline in the number of commercial banks that are truly global, that is, that have a broad-based presence with a broad-based range of services in a broad number of locations. Perhaps only 15–20 institutions will be able to afford the high cost of being a global bank.

Sovereignty

Cross-Border Electronic Banking and Runs on Countries

The conventional "nightmare" scenario of a central bank (or, perhaps more accurately, a deposit insurer) is a "run" on a bank. Now, this nightmare scenario is magnified: in part as a result of electronic tech-

nology, it is possible for a run on a country—that is, a country's currency—to occur. The 1994–95 Mexican peso crisis and 1992–93 chaos in European currency markets are cases in point. In both instances, private currency traders exhausted the resources and stamina of central banks. Their victory over the central banks is well documented by Gregory J. Millman in *The Vandals' Crown*.[26] This victory was made possible by cross-border electronic banking technologies. Traders could sell pesos, pounds, and francs so quickly and in such large volumes that central banks could not possibly control the markets, or even stem or reverse market trends.

Autonomy and Discipline

These cases suggest that the autonomy traditionally enjoyed by central banks is under siege from banks employing sophisticated computer programs to buy and sell vast amounts of financial instruments in short periods of time. Electronic technology available to, and even developed by, banks undermines the ability of central banks to manage trading prices and volumes. Every central bank must worry about a run on its currency. If such a run occurs, then a central bank has two unattractive choices: (i) allow its currency to depreciate significantly, which harms importers and can cause import-driven inflation, or (ii) raise interest rates, which may make its currency more attractive to foreign investors but also damages the domestic economy.

Interestingly, the vulnerability of central banks to currency market forces resulting from cross-border electronic banking may not constitute an entirely unwelcome development. To the contrary, cross-border electronic banking facilitates the ability of markets to impose economic discipline on countries. A central bank can prevent a run on its country's currency only through sound and transparent monetary and exchange rate policies.[27] A central bank that fails to engage in such policies risks swift reaction from traders using computers, telephones, faxes, and other electronic communication networks. In brief, cross-border electronic banking technologies provide markets with the means to penalize rightly a central bank that does a poor job of managing its economy.

Cross-Border Electronic Banking and Traditional Jurisdictional Bases

Cross-border electronic banking has far-reaching implications for the jurisdiction of a central bank to regulate the affairs of banks. In brief, it threatens to erode traditional bases for assertions of jurisdiction. These bases are derived from public international law doctrine.

Jurisdiction as Power

As a threshold matter, the core idea behind jurisdiction is power and, in the banking context, the power of a central bank to regulate transactors and transactions. Jurisdiction is a critical element of the authority of a central bank. There are three categories of jurisdiction: prescriptive, adjudicatory, and enforcement.[28] Prescriptive jurisdiction refers to the power to make rules, that is, to legislate. It raises the following questions, What is the scope of application of a central bank rule? On what banks and transactions is the rule binding? Adjudicatory jurisdiction pertains to the power to hear and render decisions in disputes. It raises the following question, Does a central bank have authority to subject a bank to the central bank's adjudicatory process? Enforcement jurisdiction concerns the power to enforce rules and decisions. It raises the following question, Can a central bank use its resources to induce or compel compliance with its regulations and decisions?

The Territorial, Effects, and Nationality Principles

Public international law doctrine answers these questions through principles or bases that a central bank can invoke to claim prescriptive, adjudicatory, or enforcement jurisdiction. These principles relate to (i) territorial, (ii) effects, and (iii) nationality.[29] In order for a central bank to have prescriptive, adjudicatory, or enforcement jurisdiction over a cross-border electronic banking transaction, or the transactors, it would have to be able to invoke successfully one of these bases. In considering each basis, the key question is the impact, if any, of cross-border electronic banking.

This question, and the tension it raises, can be explored by using the following hypothetical case. The case involves a yen-U.S. dollar foreign exchange transaction between Indian and Malaysian banks. The deal is negotiated through an electronic direct-dealing system owned by a U.S. company. The trade is settled over the wire transfer systems in the United States and Japan. Which central bank has jurisdiction over this transaction? Should the Board of Governors of the Federal Reserve (the Federal Reserve) and the Bank of Japan have jurisdiction because the trade involves dollars and yen and because CHIPS, Fedwire, and the Bank of Japan Netting System (BOJNET) are used? Should the Reserve Bank of India and Bank Negara Malaysia have jurisdiction because the counterparties are from those countries? Should the transaction be segmented in some fashion so that different central banks have jurisdiction over different parts of the deal?

First, consider the *territorial* principle. It indicates that a state has jurisdiction with respect to conduct that wholly or substantially takes place

within its territory or the status of persons and interests present within its territory.[30] The difficulty in invoking this jurisdictional basis in the context of electronic banking is the cross-border and intangible nature of such banking. By definition, such banking entails a disregard for artificial boundaries and a dematerialization of documents. Yet, the territorial principle seems rooted in a physical approach to jurisdiction—jurisdiction turns on whether the purported object thereof exists within the given boundaries. The hypothetical case suggests that no one central bank has jurisdiction over the entire transaction. The transaction takes place in the jurisdictions where the banks are located, where settlement occurs, and—because airspace or undersea and land lines are used—wherever electronic signals pertaining to the transaction pass. This case strikes at the heart of the jurisdictional authority of a central bank. After all, the rationale for the territorial principle is that a sovereign ought to have exclusive and absolute control over its territory. However, the cross-border electronic foreign exchange trade ignores territory and creates little (if any) paper trail.

Second, consider the *effects* principle, which is an aspect of jurisdiction based on territoriality. It has two dimensions. A state has jurisdiction over conduct occurring ***outside*** its territory if that conduct only has effects (or is intended to have an effect) within its territory.[31] Conversely, a state has jurisdiction over conduct occurring ***inside*** its territory even if that conduct only has effects (or is intended to have an effect) outside its territory.[32] The two dimensions of the effects principle noted above are formally known as the "objective" and "subjective" territorial principles, respectively.[33] With respect to the hypothetical case, both dimensions of the effects principle could justify assertions of jurisdiction by the Federal Reserve, Bank of Japan, Reserve Bank of India, and Bank Negara Malaysia. Each central bank could claim legitimately that an action occurring outside its territory affected its banking system or that an action occurring in its banking system had effects overseas. Thus, the effects principle is not helpful in sorting out who has jurisdiction because it answers "everybody." In turn, it may be argued that cross-border electronic banking challenges the uniqueness of a central bank's sovereignty. The effects principle amounts to an extension of the territorial principle. The essential underlying notion is that sovereignty (and central bank authority) are diminished if a sovereign (or its central bank) cannot control activities that impact on, or originate in, its territory. However, if all of the central banks have jurisdiction based on the effects principle, then the claim is hardly unique.

The ***nationality*** principle is a third basis for deciding who has jurisdiction in the hypothetical case. This basis is straightforward: a state has jurisdiction over its nationals, which include juridical as well as natural

persons, regardless of their location in the world. Accordingly, the Reserve Bank of India and Bank Negara Malaysia have nationality-based jurisdiction over the affairs of the Indian and Malaysian banks, respectively. However, this result may not be completely satisfying because it entails a split of jurisdiction over what may be viewed as a single, integrated transaction. Moreover, depending on the corporate form of organization (that is, branch versus subsidiary) of the counterparties and the location of any parent company (that is, inside or outside India and Malaysia), other central banks also may have jurisdiction.[34]

Lex Monetae

In addition to the territorial, effects, and nationality principles, a fourth principle, lex monetae, may pose solutions to the jurisdictional issues. This Latin term essentially means "the law of the currency." This principle has been recognized as a basis for jurisdiction to prescribe in the context of a country's power to regulate its own currency.[35] The idea is that a country or its central bank can claim jurisdiction over a transaction if the transaction is conducted in its currency. Thus, for example, the United States could assert an authority to freeze all dollar-denominated assets, wherever located and regardless of who holds them, because those assets are denominated in U.S. dollars.

However, this example illustrates the unreasonableness of unduly extending the concept of lex monetae. Could the United States freeze Eurodollar accounts in the Sumitomo Bank branch in London? As the *Libyan Arab Foreign Bank*[36] litigation in the United Kingdom demonstrated, the United States had a difficult enough time freezing a Eurodollar account in the London branch of an American bank. No U.S. dollar asset holder would be safe from the limitless extraterritorial reach of U.S. jurisdiction. Not surprisingly, public international law doctrine does not recognize lex monetae as a legitimate basis for jurisdiction. As Sir Joseph Gold has written:

> There is no principle that because a country may regulate its currency, the country has legislative jurisdiction over all payments and transfers made in the currency. There is no more substance to such an alleged principle than there would be to the contention that under private international law the law of a country governs all obligations expressed in the currency of the country as the so-called *lex monetae*.[37]

All bases for jurisdiction are subject to a general requirement that they be reasonable.[38]

Lex monetae may be more readily defensible if it is qualified. For example, suppose the Federal Reserve took the position that dollar funds transfers ultimately are cleared and settled in the United States because such

transfers cross the books of the Federal Reserve Bank of New York.[39] To be sure, scholars might contest the correctness of this position.[40] Nonetheless, a logical inference from the Federal Reserve's position would be that, in this context, lex monetae is nothing more than the territorial principle. Indeed, apparently it is this inference that the Federal Reserve seeks others to draw from its policy statement on privately operated large-dollar multilateral netting systems.[41] The policy statement indicates that it is "directed toward any privately operated, multilateral netting system that settles . . . U.S. dollar obligations through payments affecting one or more accounts at Federal Reserve Banks, either directly or indirectly. . . ."[42] Accordingly, an offshore dollar clearing and settlement system that uses the books of a non-U.S. bank with no link to Fedwire or CHIPS would appear to be outside of the scope of the policy statement.

The Consent Principle

The failure of the territorial, effects, and nationality principles to resolve with certainty and predictability the jurisdictional problem in the hypothetical case, and the controversy surrounding the assertion of lex monetae, highlights the need to place renewed emphasis on a different approach to jurisdiction, namely, the consent principle. This principle is an accepted part of public international law doctrine and a suitable basis for jurisdiction in the cross-border electronic banking context.

The consent principle provides that a state has jurisdiction to prescribe and enforce a rule of law in the territory of another state to the extent provided by international agreement with the other state. It seems unwise to recharacterize the hypothetical foreign exchange transaction as a series of elementary steps simply to support multiple jurisdictional claims. In fact, the transaction is a single, integrated one: the terms of the deal, such as the exchange rate and amount, events of default, collateral or other security arrangements, and settlement instructions, are integrally related to one another. The more prudent route appears to be an a priori multilateral jurisdictional agreement among central banks, that is, jurisdiction based on consent.

Such an agreement (which could be negotiated under the auspices of the International Monetary Fund) might consist of three basic parts. First, the agreement could specify the types of cross-border electronic banking transactions to which it applies. It could define these transactions in terms of the financial and commercial categories addressed previously in this chapter. Second, the agreement could articulate tests to establish which central bank would have jurisdiction over a given type of transaction. These tests would resolve the difficulties identified above with the tradi-

tional territorial, effects, and nationality principles. They would, moreover, ensure that at least one central bank has a bird's-eye view of a transaction at issue. Third, the agreement would commit central banks to share information with one another in order to facilitate the exercise of jurisdiction by a single central bank in a particular case. This commitment could resemble the information-sharing guidelines that the Basle Supervisors Committee published in the wake of the BCCI affair.[43] The agreement need not necessarily intrude on the nascent self-regulatory initiatives of the Basle Supervisors Committee. The agreement simply would spell out which central bank has primary regulatory jurisdiction in the event that it becomes necessary to exercise such jurisdiction.

Conclusion

Cross-border electronic banking connotes dematerialization, that is, the computer-to-computer exchange of data in preset formats. Banks use electronic technology to facilitate their roles as intermediaries and participants in trading financial instruments and foreign exchange. This technology may exacerbate certain components of systemic risk, namely, market liquidity, settlement, and operational risk. However, the technology also offers banks the ability to better monitor and perhaps even reduce market risk. Electronic technology facilitates runs on countries and challenges traditional concepts of jurisdiction. Nevertheless, it also highlights the need for central banks to redouble their efforts to reach agreement on supervising cross-border electronic banking transactions.

COMMENT

JAMES E. BYRNE

Cross-Border Electronic Banking: Some Reflections on Its Implications for Central Banks

The technological and communications revolution unleashed by the business and financial communities has engulfed banking. What its full implications will be is impossible to assess at this time, but it is clear that it will affect every dimension of finance and banking. Chapter 5 examines the implications of this revolution for central banks, focusing on two important aspects: use of private market-risk systems as a supplement to direct regulation, and cooperation among regulators in the form of a multilateral agreement, possibly under the aegis of the International Monetary Fund. This comment explores the advantages of regulation by private rule making and emphasizes the need for collaboration among bank regulators.

Need for Harmonization

Major commercial banks undertake transactions with cross-border elements thousands of times a day. Even banks with wholly domestic operations must maintain a correspondent relationship or relationships to offer their customers the array of services now required of commercial banks. As a result, it becomes increasingly difficult in practice to distinguish between a domestic and a cross-border transaction because many apparently domestic transactions have underlying cross-border dimensions. Because of the global character of these transactions, the need for integrated and consistent rules, regulations, and laws is critical. It is not feasible, nor is it desirable, to have separate provisions for municipal transactions (even assuming that it is possible to isolate them, given the global character of banking) on the day-to-day level of practice and other provisions for international ones. While such a regime may be possible at a certain level of legal abstraction, even at this level it is highly desirable that there be harmonization.

Many issues can arise in cross-border situations. They challenge banks and their regulators to adapt their approach to this new reality. While a systematic evaluation of the implications of electronic banking probably can only be written by virtue of hindsight, it is possible to offer several observations on discrete issues of relevance in this process.

Taxonomic Considerations: Toward an Understanding of Electronic Banking or Electronic Funds Transfer

There are two fundamental factors at the core of electronic banking or, for that matter, electronic commerce: rapid communication and the rapid manipulation of massive quantities of data. The latter of these two factors is relatively new, and its effect must be assessed. Although there have been significant improvements in the speed, quality, and quantity of communications, the introduction of the commercial telegraph system in the nineteenth century is the benchmark event for rapid communication. It is the ability to communicate and manipulate vast amounts of data permitted by microprocessing technology and the widespread use of such technology that have sparked recent changes.

The full implications of this revolution for banking are yet to be seen, but they have already had a profound influence on domestic and international banking. It is almost axiomatic that such changes increase opportunities and risks. For bank regulators and central banks, this phenomenon requires diligent observation and study.

The starting point in assessing the effect and increased risk of electronic banking is not banking itself but the commercial system that it serves. Electronic commerce has radically altered the face of business and accelerated the trend toward globalization of markets and businesses. In order to meet the changing needs of their customers, banks have had to change as well. The customer base serviced by the international banker remains the same—corporate and financial (correspondent banks) customers—but the needs of these customers are increasingly global and change at a sometimes dizzying pace. A corollary of this observation is that, while banks will rarely lead technological revolutions, they will closely follow them.

One consequence of these developments is the rapidly increasing globalization of banking. Currently, there are two prototypes: (i) the global bank that is present in every significant national market to provide a full array of commercial (including retail) banking services; and (ii) the global correspondent bank that has cultivated a correspondent network, which it services without offering direct competition across the board in the domestic market. There are, of course, interim positions where banks carve out niches in a region in which they can offer all services and market them to correspondents, enabling these banks to compete with global banks in their domestic market. Whatever the model, or to what degree it is followed, no commercial bank can expect to continue functioning unless it is linked in some fashion to a global banking network. While these developments have not as yet altered the categories of risk that must be taken

into account by the central banker, they do affect these risks and decrease the time within which they can be usefully recognized and addressed.

It is premature and may be misleading to attach too much significance to a precise definition of electronic banking.[1] While more precision may be needed for the purposes of statutory drafting, the watchword should be flexibility. The technologies and possibilities involved are subject to rapid change. For example, it is unclear whether preformatting into data fields will continue to be a requisite and what role imaging technology will play. For regulatory purposes, any technological development that increases information flow and business possibilities should be of interest, regardless of whether it falls within a precise definitional category. To limit the scope of inquiry further is unnecessary. Given the current exponential increase of technological advances, it is unclear what constitutes a computer and whether linkage need be "computer to computer." Current technologies permit voice and even written access. It is difficult to predict the shape of future hardware, software, or user configurations.

The Effect of Electronic Banking on Risk

The precise effect of electronic banking on risk is difficult to predict with any precision and will remain so until the occurrence or nonoccurrence of a crisis permits a careful assessment. Nonetheless, it is possible to anticipate the potential impact of electronic banking in general terms.

In the first place, it should be recognized that, as with all technological developments, there are both positive and negative dimensions from a regulatory and safety and soundness perspective. The very speed and mass assimilation of data that can compound problems can also place in the hands of regulators information heretofore unavailable and permit the early identification of trends.

Second, it is not likely that electronic banking introduces new risk per se, but more likely that it increases the possible types of risk in traditional categories.[2] Moreover, it may increase the possible dimension of any crisis because of the increased linkage of the global financial system and the capacity for rapid transmission of information.

Some examples of increased risk include technical incompatibility of systems, system malfunction, and system failure due to internal or external causes, access or intervention by outsiders, viruses, and absence of laws or regulations addressing issues raised by electronic banking. The linkage of banks within a country through electronic banking may also increase country risk. In addition, there are specific operations issues that arise, as well as public policy issues, where governments seek to monitor payments (for example, boycotts or money-laundering policies) in order

to implement foreign policy objectives that are unrelated to the safety and soundness of the system.[3]

The possible ramifications of electronic banking in recent crises remain to be fully documented. The Bank of Credit and Commerce International (BCCI) scandal, the Mexican peso crisis, the Baring's collapse, the Daiwa loss, and the as yet undocumented difficulties with the Japanese bank system as a result of real estate losses are only partially understood. In each crisis, however, it appears that the magnitude of the problem was exacerbated by the global linkage of banks within the world financial system, making even greater the impetus for a swift international response.

Considerations in Formulating a Program

While it is not yet possible to offer a definitive program to address the increased cross-border risks introduced by electronic banking, several observations are in order.

Need for Harmonization and Upgrading of Domestic Law

It must be determined whether municipal legal infrastructures are capable of handling disputes arising from electronic banking. There are two aspects to this question. The first applies generally to all issues relating to electronic data interchange and involves fundamental questions. These matters include formal requirements (whether a writing is required, what constitutes a writing, and what constitutes an enforceable authentication or signature), classification (is the undertaking to be treated as a traditional bilateral contract and, if so, is such treatment consistent with the expectations of the parties), and the extent to which party autonomy can supplement or derogate from municipal law. In addition, there are specific issues regarding the legal regime to be applied to the specific area involved, such as funds transfer or foreign exchange. This would include questions as to the nature of the underlying transaction: when it becomes operative and binding; when and how it can be modified; the aspects of finality, mistake, and damage; and, where applicable, the impact on third parties, with concomitant questions on the applicability of the doctrine of abstraction.

In this regard, various legal systems are struggling to update in order to accommodate electronic commerce and banking. These varied efforts make issues of choice of law and choice of forum highly significant.

The efforts of the United Nations Commission on International Trade Law (UNCITRAL) are of great significance in this respect. UNCITRAL has produced two products that represent the collective efforts of its

members, the Model Law on International Credit Transfers[4] and the Model Law on Electronic Commerce.[5] These models should be given serious consideration in the formulation of municipal laws, in part because of the need for harmonization in this field and in part because they represent a solution that has attracted broad support.

The Need for International Regulatory Coordination

If electronic banking makes harmonization of relevant legal regimes significant, it makes coordination of regulatory efforts essential. The increasing globalization of banking permitted by electronic banking places serious pressures on the regulatory system. Recent difficulties such as those encountered by Banco Nazionale del Lavoro or the BCCI scandal have awakened the regulatory community to the need for assessment of the safety and soundness of nondomestic bank operations. The work of the Basle Committee on Banking Supervision in evolving capital adequacy requirements to be applied in member countries is an example of the type of coordination that will become increasingly important.[6] A sound regulatory scheme may involve coordination between bank, security, and insurance regulators.

Unfortunately, there exists no definitive study of the effectiveness of this Basle Committee initiative and such an analysis is necessary for further efforts. Not only is there a need for judicious use of regulatory powers on an international level, but there is also a need for assurance that the results are implemented consistently. With regard to the capital adequacy requirements, for example, questions remain as to the effectiveness of the system of risk measurement employed, its application in various countries, the classification of certain types of undertakings, and its effect on other devices.

For example, the capital adequacy rules effectively stalled an increase in the use of standby letters of credit in the United States.[7] While this development may lessen concerns about this type of balance sheet obligation, the experience of relief should not mask serious questions about the application of alternative devices in situations where there are no reported figures and, consequently, increased domestic risk. As applied, the capital adequacy guidelines made increased use of these technically understood and relatively safe instruments less attractive to the money center banks who were the ones best suited with sufficient expertise to handle the operational risks involved in them. Since the appetite of banks for profits has in no way been lessened by the capital adequacy rules, it also remains to be seen if the direction in which bank energies have been turned are equally useful and predictable or less so. Indeed, the increased sale and marketing of derivative products and the resulting confusion

might be explained in part by the need to develop alternative bank service products. What is needed after the decade in which they have been in effect is a complete reevaluation of the capital adequacy rules on a macro and micro level to address their influence, the lessening (if any) of risk, and the need for refinement as a model for future efforts.

Systemic Rules and Rules of Practice

Chapter 5 properly notes the historical significance of supervisory deference to bank risk-measurement systems.[8] The appreciation of such systems should, however, extend beyond this limited scenario. One of the hallmarks of electronic banking is the evaluation of integrated systems. Funds transfers are the best-known example. These systems are subject to rules that provide norms, discipline, and internal regulations. In a sense, they order the transaction on an immediate day-to-day level and reflect the collective experience of the system members. The members of these systems not only share the regulator's concerns for safety, soundness, and integrity of the system, but have a unique practical perspective on various types of risk and effective countermeasures.

Rather than duplicate these efforts, regulators should work closely with such systems where they exist and consider how to enhance their effectiveness. Members are likely to be acutely sensitive to system risk imposed by the behavior of other members, and it is the ability of such fault lines to signal risk that should attract special attention. The prime regulatory effort, then, should be to encourage sound rule making and enhance its effectiveness when present.

This conclusion obtains not only for formally established systems, such as a funds transfer system with membership requirements and a formal rule making process, but to other widely followed rules of practice as well. In this sense, rules of practice are those widely adhered to without the existence of a closed system. The best example is afforded by the Uniform Customs and Practice for Documentary Credits (UCP),[9] which sets forth rules for commercial letters of credit. The UCP represents a systemic and integrated approach to letter-of-credit transactions. It is intended to operate as the source of law for a letter of credit that is subject to it, and sound commercial law and judicial decisions have given the UCP due deference.[10]

Little attention has been given to the similarities between closed systems, such as a funds transfer system—for example, the Clearing House Interbank Payment System (CHIPS), the Society for Worldwide International Financial Telecommunication (SWIFT), or Fedwire—and open systems of rules, such as the UCP. In an innovative provision, Article

4A of the Uniform Commercial Code (a domestic model law that has been adopted within the United States) defers to a "funds-transfer system rule" "even if the rule conflicts with this Article and indirectly affects another party to the funds transfer who does not consent to this rule."[11] It also provides that the rule may govern the "rights and obligations of parties other than participating banks using the system" in certain situations.[12] As noted in Official Comment 1, Section 4A-501 provides not only that system rules supplement the statute but, to the extent that it may be derogated from, such rules "override" it.[13] While this rule may be self-evident in some systems of jurisprudence, it is not always apparent in other jurisdictions. More remarkable, however, is the departure that this provision represents from the fiction of giving effect to the intention of the parties, which is a consequence of traditional nineteenth century contract law. Upon reflection, it is irrelevant whether or not the parties have intended to agree to system rules. What matters is that they chose to use the system. If so, they must be bound by its rules in order to enable the system to function.

Under Section 4A-501(b), this concept is linked to the defined concept of a "funds-transfer system rule" which is

> a rule of an association of banks (i) governing transmission of payment orders by means of a funds-transfer system of the association or rights and obligations with respect to those orders, or (ii) to the extent the rule governs rights and obligations between banks that are parties to a funds transfer in which a Federal Reserve Bank, acting as an intermediary bank, sends a payment order to the beneficiary's bank [Automated Clearinghouse transfers].[14]

On its face, the provision applies to an association of banks and gives effect to their rules among themselves. It goes beyond this notion, however, at least to some extent in the provision indicated above, which applies the rules to nonmembers who opt to use the system itself without membership in it or, arguably, even knowledge of its rules.

This approach is consonant with commercial jurisprudence, which should foster sound rule making if it is a more effective means of ordering the behavior of the parties than legislation or regulation by governmental agencies. What it fails to address, however, is how to encourage sound rule making, and how unsound or biased rule making can be discouraged. It is the fear of self-serving rules that stimulates opposition to private rule making—the fear that groups with vested interests will create rules that are biased in their favor and will use these rules to the disadvantage of others who are not members of the group but who must use their system. Often such biased rule making is linked with economic leverage over the nonmember users.

One of the keys to sound rule making is to find rules that are promulgated by trusted brokers in the given market. These brokers are in the

middle of multiple transactions and could not operate under rules that are not essentially neutral and that do not reflect the commercial expectations of the parties. With respect to funds transfers (as is the case with many banking transactions), the trusted intermediary is the clearing bank—for example, in New York, the money center banks that dominate the funds transfer business. Because they must occupy virtually every position in a funds transfer at any given moment and because they are attuned to the commercial and financial realities behind a funds transfer, they are apt to be in a good position to formulate neutral rules. To the extent that these rules are accepted in the various systems, they should be given deference.

What is unclear from this approach, however, is the formality of the system in which the rules operate. For example, must they be linked to a funds transfer system in the sense of rules emanating from an association of banks? The suggestion from the experience of letter-of-credit law is that such a formal system is not necessary. The evolution of rules and the process of rule making for letters of credit demonstrate that it is possible to formulate what is in effect a system of rules that receives virtually universal adherence and to which each individual transaction is subjected without a formal system. The lesson to be learned from the letter-of-credit experience is that rules created by informal systems can be as efficacious as those emanating from formal systems and can affect all the parties to the transaction. There can be no realistic suggestion here of "agreement" in the normal sense with respect to the undertaking between the issuer and the beneficiary of a letter of credit. Nonetheless, the UCP has brought order to this field internationally. This has served as a basis for its widespread use and acceptance as an indispensable tool of commerce.

What is even more significant about the UCP and funds transfer system rules is that they are more than mere supplementary sources of the terms of the contract—contractual terms by incorporation. While there certainly is an element of contract interpretation in the application of all system rules, they involve elements that are very different from what is usually meant by incorporation of terms into a contract. Most significantly, they provide an integrated system of rules that are intended to oust traditional legal and equitable analysis where they apply. Thus, these systems not only supply a remedial scheme, define rights and obligations, and indicate when they are operative and when they terminate, but also contain their own jurisprudential approach, founded typically on principles of mercantile law.

One of the advantages of such rules is that they can operate in situations where there is no international legal regime. The UCP, for example, has

operated in an international environment that has largely been bereft of legislation and in which judicial decisions were typically few and of limited use.

Conclusions

Cross-border electronic banking poses unprecedented challenges and opportunities to the current nation-based system of banking regulation and to central bankers. The speed with which enormous quantities of information can be moved and assessed provides considerable advantage to the entity with the ability to access and act on it. Any response to this phenomenon must take into account the need for coordination and restraint. Its effectiveness may well depend also on the ability of bank regulators to harness systems within the international banking community that work to ensure balance, harmony, and order. To the extent that central bankers can encourage the development of sound methodology and practices—whether within one bank, as suggested in Chapter 5, or within entire areas of international banking—the process of maintaining safety and soundness in banking will be greatly enhanced.

Hypotheticals

The possible implications of cross-border transactions for banks and banking regulators can be illustrated by three hypotheticals based on everyday transactions involving daily activities of commercial banks related to funds transfers and trade finance.

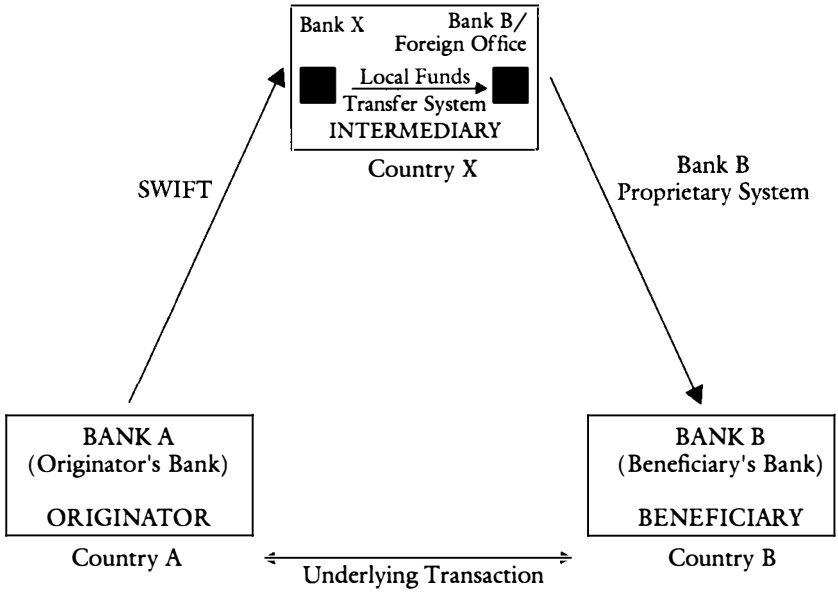
Hypothetical Number 1

The originator in Country A initiates a payment order payable to Beneficiary B in Country B, placing it with Bank A in Country A (Originator's Bank) (see Figure 1). The order is transmitted through SWIFT payable in the currency of Country X and transmitted through an intermediary bank in Country X (Bank X), which is a correspondent of the originator's bank. That order is transmitted within Country X through a local funds transfer system to a Country X branch of the beneficiary's bank (Bank B), which is headquartered in Country B. The payment order is then transmitted to the head office of Bank B in Country B through a proprietary system.

The transaction is for the sale of equipment whose production and sale are legal in Country A, but whose purchase is restricted in Country B, where the seller is from Country A. The laws of Country X forbid any action in furtherance of a prohibition such as that imposed by Country B.

- What if the transaction is a "pass through" handled automatically by computerized equipment without any human intervention in Country X?

Figure 1



- What if the funds transfer system rules make the transaction effective in Country B on its receipt? What if the laws of Country B have this effect?
- Is the office of Bank B in Country X governed by the laws of Country B or X?

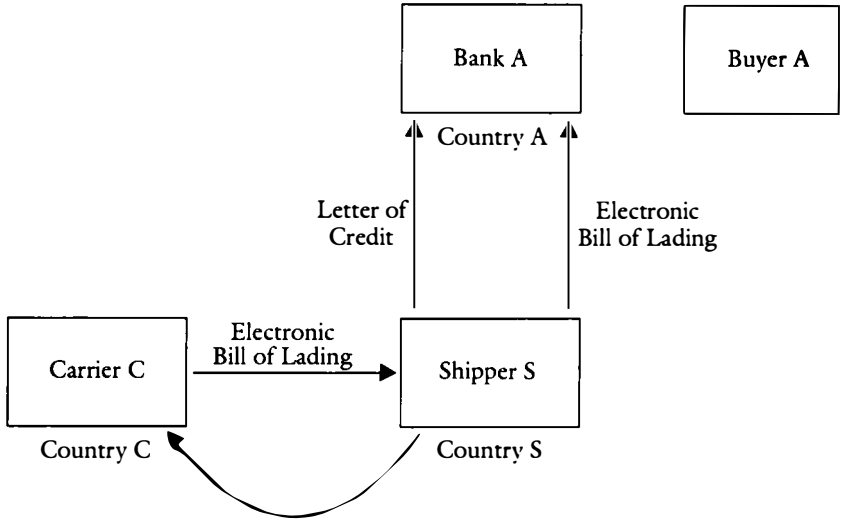
All three countries require the banks requested to implement the transfers to monitor compliance with their various policies and impose heavy fines for violations.

- Does it make any difference if the data fields for the multilateral system (SWIFT) do not permit transmission of the requisite information?
- To what extent should the branch office of Bank B located in Country X be required to facilitate the policies of Country B when they run contrary to the policies of Country X?
- Is there any difference if the transaction at issue is one of money laundering or for a shipment of nuclear arms?

Hypothetical Number 2

Bank A in Country A regularly engages in trade finance, extending credit against documents of title (such as bills of lading), issuing letters of

Figure 2

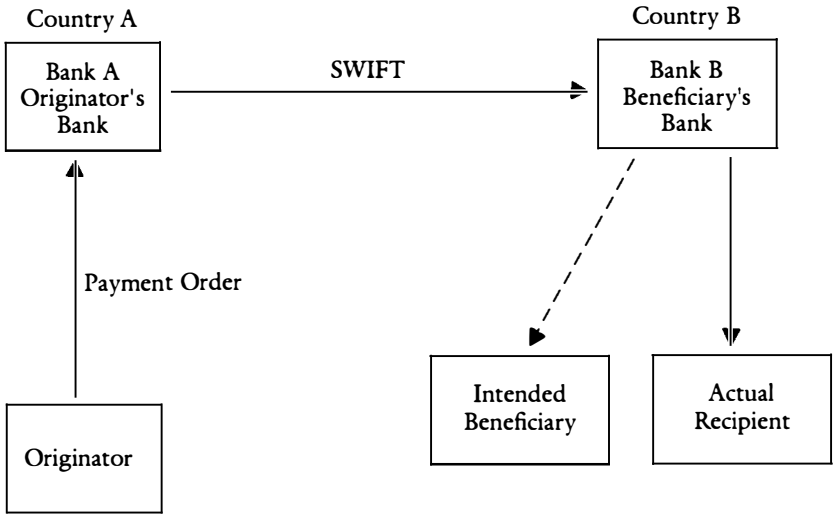


credit specifying presentation of such documents, and issuing trust receipts (see Figure 2). Carrier C, whose ships are registered in Country C, issues an electronic bill of lading to Shipper S located in Country S who causes it to be transmitted and transferred to Bank A, which has issued a letter of credit calling for presentation of electronic bills of lading on behalf of Buyer A in Country A. Can and should Bank A make such an undertaking? What are the legal, regulatory, and business considerations that would affect such a decision?

Hypothetical Number 3

Bank A in Country A transmits a payment order through the auspices of SWIFT on behalf of Customer A (see Figure 3). Customer A, a corporation, provides an erroneous account number but the correct name of the beneficiary bank (Bank B in Country B). Relying on the number, as it is entitled to under SWIFT rules, Bank A transfers the funds to Bank B in Country B who pays the funds into its corresponding account number. The holder of that account (who was not the intended beneficiary) absconds with the funds. When the intended beneficiary does not receive the transfer, inquiries are made and the misrouting is discovered. Litigation ensues.

Figure 3



- What should be the source of the rules that resolve the dispute and of the beneficiary's claims for the transfer and consequential damages, the claims of Bank B and Bank A for reimbursement and interest, and the claims of the originator for the funds charges against its account and consequential damages resulting from losses experienced in its dealings with the intended beneficiary?
- Should this source be the law of one of the countries? If so, which law—the law regarding litigated contracts, commercial paper, abstract undertakings (assuming that there is no "law" for electronic funds transfer); the UNCITRAL Model Law on International Credit Transfers;[15] or the SWIFT rules?
- Would there be any difference (assuming that the issue was governed by the SWIFT rules) if the error were made by one of the banks or if the error were due to a telecommunications failure of a third-party network?
- Assume that the actual recipient had relied on and spent the funds. What rules should govern the ability of whoever bore the loss to obtain reimbursement? Should it make a difference which party bore the loss?

Afterword to Chapters 4 and 5

THOMAS C. BAXTER, JR.

Chapters 4 and 5 on foreign exchange settlement risk and cross-border electronic payments raise an interesting issue. Do these transactions involve (i) a delivery against payment, or (ii) a payment against payment? For example, assume that a person purchased apples with dollars instead of a foreign currency. Apples are a commodity and, as such, they get delivered rather than paid. This purchase, therefore, involves a delivery of apples against payment in dollars. However, what if a person buys francs instead of apples? Does he or she have a delivery of francs against payment in dollars or a payment of francs against payment of dollars? The answer is significant because it will lead to the application of one of two different legal regimes.

One of the interesting facets of U.S. law is that francs, at least in some U.S. courts, are considered to be a commodity, while dollars are not.[1] Some courts view trading dollars for francs as a transaction governed by Article 2 of the Uniform Commercial Code (UCC) covering the sale of goods. Thus, if a party pays dollars into an account and its counterparty fails before it can deliver the francs, the party who performed can void the contract and recoup the dollars.[2]

Assume, however, that the transaction involves trading yen for francs. Is this a delivery against payment or a delivery against delivery—essentially, a barter transaction? These examples show the absurdity of conceptualizing a foreign exchange transaction as a "delivery" or a "payment" because, depending on the type of foreign exchange involved in the transaction, a different legal rule may apply to determine whether the contract has been performed. Why should courts view francs or yen as a commodity, but not dollars?

Arguably, the appropriate way to think about a foreign exchange transaction is to consider it an exchange of bank credit, even though it is bank credit denominated in different currencies. The exchange, therefore, is not francs for dollars, but bank credit denominated in francs for bank credit denominated in dollars, or bank credit denominated in yen for bank credit denominated in francs. As such, one law would apply to all foreign transactions regardless of the currency involved. In the United States, Article 4A of the UCC would apply and, internationally, possibly a law based on the UNCITRAL Model Law on International Credit Transfers might govern the transaction.[3]

Foreword to Chapters 6 and 7

OLIVER IRELAND

Chapters 6 and 7 focus on two somewhat disparate payment systems: electronic cash, or e-cash, including stored value cards, and checks.

E-cash, at least in the United States, is a relatively new phenomenon. While e-cash in the form of stored value cards that can be used at a variety of geographically dispersed businesses is not widespread in the United States, it is nevertheless a phenomenon that has drawn a great deal of interest.[1] Similarly, the use of the Internet for payment transactions has drawn much interest in this country, but the amount of its actual use is relatively small and difficult to measure.[2]

Not surprisingly, in the absence of general use of stored value cards and use of the Internet for payment purposes, the state of the law of payments by means of stored-value cards and the Internet in the United States is relatively undeveloped. In these circumstances, judicial resolution of any problems that arise will likely be through reference to existing principles and rules for other payment media and general principles and rules for contractual arrangements.

Some view this lack of development of the law as a void that needs to be filled to provide certainty and to avoid the costs of litigation. This view values the advantage of certainty over the potential benefits of innovation. Others view this lack of development of the law as a fresh canvas on which innovative new arrangements can be explored, free of the constraints of rules established for other payment systems.

To take one example, a simple thing such as a discharge rule—that is, a legal rule as to when an obligation for which a payment is being made is discharged—could have constraining effects. In the United States, there is one discharge rule for checks drawn by individuals[3] and a different rule for checks drawn by banks.[4] The theory is that banks are more creditworthy than individuals and, therefore, that an obligation can be discharged by the mere delivery of a check drawn by a bank, while the obligation is only suspended by delivery of an uncertified check drawn by an individual. What about a check or e-cash issued by a trust the corpus of which consists of short-term government securities? That trust offers a credit quality better than most banks and potentially equal to deposits insured by the government, but without the associated regulatory costs. Nevertheless, a discharge rule similar to the U.S. discharge rule for checks discourages development of such an entity. At this stage, some observers feel that it may be better to let the markets determine the acceptability of payment media, unfettered by special legal rules.

The lack of law governing e-cash and Internet payments is in sharp contrast to the process and law of conventional check collection in the United States. Here, the technology, procedures, and the law are highly developed. It is only in the area of converting paper checks to electronic signals that the process and the law are continuing to develop.

Compared to the efficiency of domestic check collection systems in the United States and some other countries, the international collection of checks must be characterized as relatively inefficient. Checks, particularly personal checks, drawn on institutions in other countries are not readily accepted in the United States, and the time for collection and return—that is, the time needed to enable the recipient of the check to feel comfortable that the check has been paid—is uncertain. Would greater legal certainty or more ready access to legal redress improve the efficiency of international check payments, or are such improvements worth the effort, given the access to other existing and potential payment media that may be more efficient?

The following chapters address e-cash and such other established payment media as checks. In an increasingly global economy, the issue is of concern to all central banks and particularly to their lawyers.

Chapter

6 Stored Value Products: A New Legal Challenge

THOMAS C. BAXTER, JR.[1]

Electronic money, or stored value products, is a new frontier for retail payments systems whose technology is rapidly evolving, with new products and developments being announced almost weekly. In comparison, the legal rules governing such products are undeveloped and uncertain. Legal uncertainty is of some concern because monetary history, at least in the United States, suggests that it may undermine public confidence in a payments system, particularly if there are any questions about a system's ability to deliver good value. In turn, legal uncertainty may stifle development of a desirable payments system—even one that is as economically efficient as electronic money promises to be—if it is too difficult for users of the system to ascertain and appropriately control risks. At the same time, adopting rigid legal rules is not the answer because this too can hamper product development. What is needed then is a happy balance—sufficiently clear legal rules to assess liability and risk, without their being so costly and constraining that they become an iron cage.

Striking the right balance may not be easy. As a starting point, it may be useful for a central bank to review the legal or regulatory rules that apply to payments systems currently operating in its country. In the United States, retail payments systems include cash, checks (including bank, cashier's, and traveler's checks), and consumer wire transfers. The rules that apply to these systems serve as a useful reference point for a discussion of electronic money or stored value products. The first part of this chapter briefly describes stored value products and discusses their credit feature. The second part explores the evolution of a stored value product from creation, through its transfer, to final settlement. This part also discusses the importance of adopting a finality rule. The last part examines some issues of particular relevance to central bankers, such as choice of law and the risks associated with cross-border transactions.[2]

An Overview of Stored Value Products

In the United States, both banks and nonbanks are developing stored value products for a variety of purposes. Understanding how these products work is an important first step in developing an appropriate legal and regulatory structure.

Description of the Products

Models for stored value products vary widely. The simplest model is one issuer supplying cards for a limited purpose, such as purchasing bus transportation. For example, a commuter may purchase a card for $10 from a bus company and $10 of value will be embedded on a magnetic strip on the card. When the commuter rides the bus, he or she will pass this card through a reader, and the reader will debit the amount of the bus fare, resulting in a new card balance. This model poses few legal issues because the issuer, in this case, the bus company, is readily identifiable and is also the one providing the service.

The more sophisticated stored value products operate in a somewhat different fashion. In most cases, the issuer of the "value" will not be the entity providing the goods or service. A single issuer may develop and issue the value on a card but employ other firms as members of its distribution network both to sell the cards and redeem the value embedded on them. These firms act as intermediaries between the issuer and either the purchasers of the cards or the vendors who accept them as a means of payment.

Multiple issuers may also develop stored value products by adopting a common technology for the cards or other access devices, establishing a distribution network, and arranging for a mechanism for settlement. Major credit card companies have been natural developers of the common technology for these types of products because they already have distribution and settlement networks, and are accustomed to the practice of co-branding cards with names and logos of the members of their associations.

Electronic "value" can also be stored and used for transactions on computer networks (or other communications networks). In contrast to stored value cards, which are largely intended to be used for point-of-sale transactions, value stored on computer networks can be used for transactions where the buyer is at a location remote from the seller and the actual place of sale.

Credit as a Distinguishing Feature

One distinguishing feature common to all stored value products is the gap between the time when the user "pays" for the value and the time when that purchased value is redeemed. The temporal gap between the creation of the value and redemption of the value necessarily involves an extension of credit from the purchaser of the card or storage device to the issuer. In effect, when a purchaser buys a card, he or she is exchanging currency for a plastic card embedded with a kind of electronic IOU.[3] The purchaser of the stored value card will use the stored obligations embed-

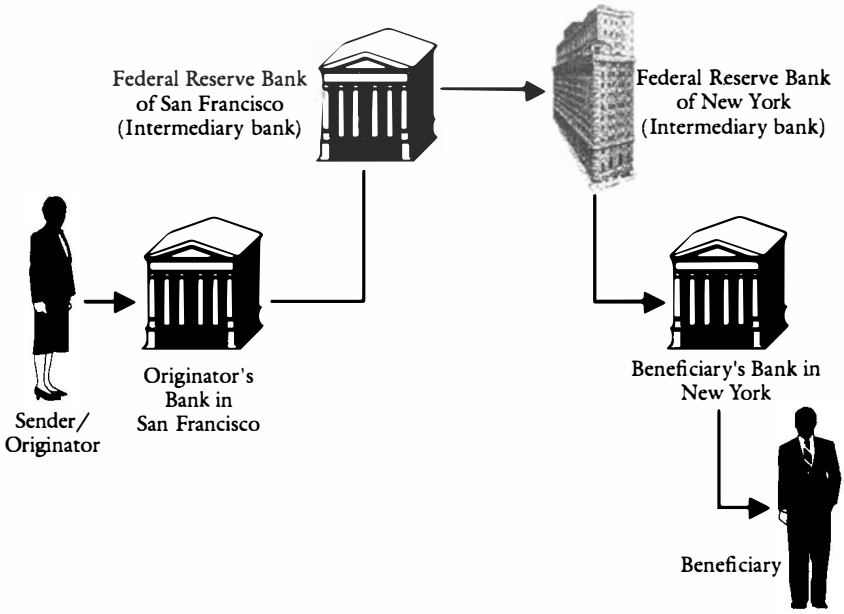
ded on the card to pay for a good or service, thereby transferring this electronic IOU to a merchant who will redeem the IOU from the issuer, usually through an intermediary.

Because these products involve the extension of credit, calling them "money" is a misnomer, if by money one means legal tender. Unlike legal tender, a person is not required to accept a stored value product in payment for a debt. Moreover, tender of a stored value product does not, as a matter of law, discharge the underlying debt obligation. Similar to credit, particularly bank credit, a stored value product may function as the equivalent of money. In the United States, particularly for large transactions, bank credit is the preferred medium of exchange. This is due in part to the presence of a clear regulatory framework that fosters public confidence that bank credit as a payment mechanism delivers good value.

Developing legal or commercial rules is important to ensure public confidence in these new payments products. In the United States, payments are made by cash, checks (including bank, cashier's, and traveler's checks), and consumer wire transfers and, basically, involve one of two payments models: a credit transfer or a debit transfer. In a credit transfer, such as a wire transfer, the originator of the transaction "pushes" credit from its bank account through the payments system ultimately to a beneficiary's account (see Figure 1). In a debit transfer, such as with personal checks, the drawer delivers an instrument to a payee, who deposits it into its bank account and uses the instrument to "pull" funds from the drawer's bank account to the account of the payee (see Figure 2). The legal rules in the United States that apply to a credit transfer on the one hand and a debit transfer on the other are clear but quite different.

Stored obligations have elements of both a credit transfer and a debit transfer (see Figure 3). At the time of creation, the purchase of a card with value looks like a credit transfer or funds push—the card purchaser is pushing funds out of its account into the account of the issuer. At other times, however, the transaction looks more like a debit transfer or funds pull, as when the vendor redeems a stored obligation from the issuer. (Of course, unlike most debit transfers, the redemption of stored value does not result in funds coming out of the payor's own account.) The wholesale application of one set of rules to stored value products, therefore, is not appropriate. Rather, stored value products must be viewed as a new hybrid payments system that is a crossbreed of the debit and credit transfer. As such, existing legal rules—either through contract, regulation, or statute—will not fit them well, and there may be a need to develop specific rules for the new products.

Figure 1: Funds Transfer
(A Credit Transfer)



The Evolution of a Stored Obligation

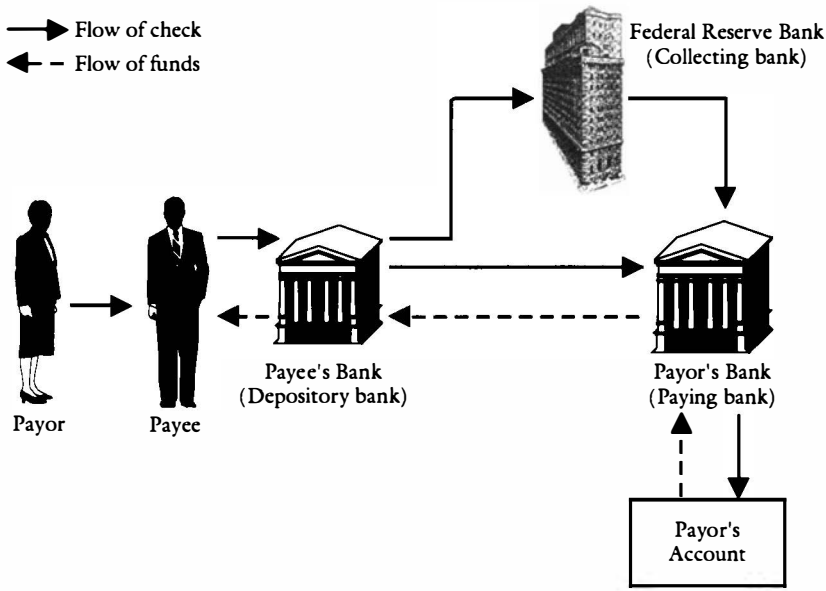
To analyze this potential need, it is useful to view a stored obligation as having three distinct phases: the creation of the value; its transfer; and, finally, settlement and discharge. By focusing on each of these stages, it may become clearer when commercial law issues can be resolved by a written contract between parties to the transaction or when a special legal rule is necessary.

Creating the Value

The first stage is the creation of a stored obligation on a device. The analysis that follows assumes that the storage device is a plastic card with the name of the issuer emblazoned across the front, but similar concepts would apply to computer storage devices.

A threshold question is, When is an obligation of an issuer created? Simply manufacturing the cards, even if stamped with the issuer's name or trademark, will not create an obligation. At this stage, the card is simply a storage device that has marginal financial consequences for the balance sheet of the issuer. One would expect that the creation of the

Figure 2: Check Collection Process
(A Debit Transfer)

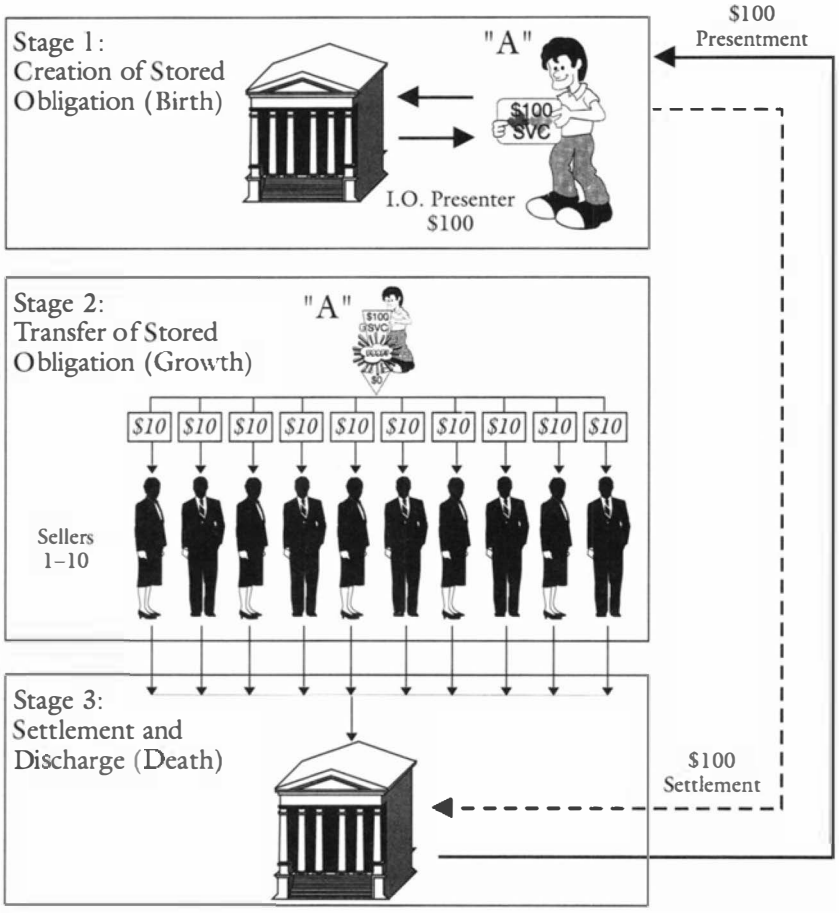


obligation generally will occur when money is exchanged for the stored value and the issuer increases its liability side of its balance sheet. Theft of the plastic cards before they are loaded with value will not create an obligation, but counterfeiting the cards might, particularly if the issuer supplies or controls the encryption technology that determines at the time of transfer whether a stored obligation is authentic.

Another issue concerns the identity of the obligor and the ability to determine whether the obligor is creditworthy. Assume that "A" purchases a stored value card with cash or a bank check. For A's cash or check, the obligor gives A an IOU in the form of a plastic card embedded with value (see Figure 4). If A uses the plastic card to buy a hat, and the hat seller accepts the card as payment, the card's obligor then becomes indebted to the hat seller, identified in Figure 3 as "I.O. Presenter." The only way for A to measure the credit risk associated with purchasing the card and for the hat seller to measure the credit risk associated with accepting the value stored on A's card as payment is to know the identity of the obligor. However, identifying the obligor may not be so easy. For example, the entity selling the plastic card may not be the entity that issued the value on the card, that is, the obligor. Unless the identity of the actual obligor is disclosed prior to the purchase of the card, the card's purchaser may never know that its credit risk

Figure 3: Stored Value Card

(A Credit or a Debit Transfer?)



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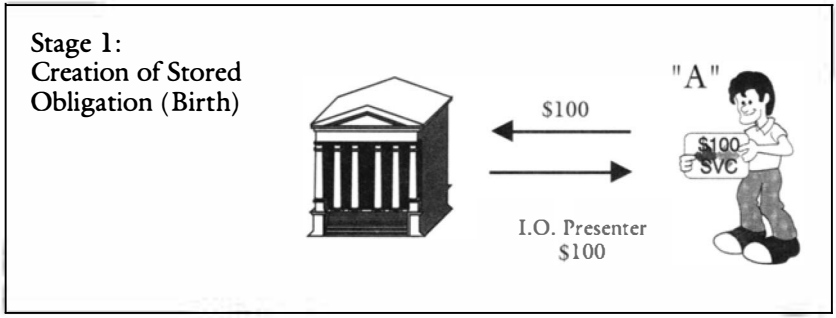
is ultimately with someone other than the entity that sold the card. To reduce confusion, it would be best if the identity of the entity (or entities) that are liable to pay the stored obligation is disclosed at the time a card is purchased. Absent disclosure, a court could hold any entity identified on a card (or other access device) liable to the card purchaser as the agent of an undisclosed principal, or as a guarantor in much the same way an endorser of a negotiable instrument can be held liable.

Figure 4: Creation



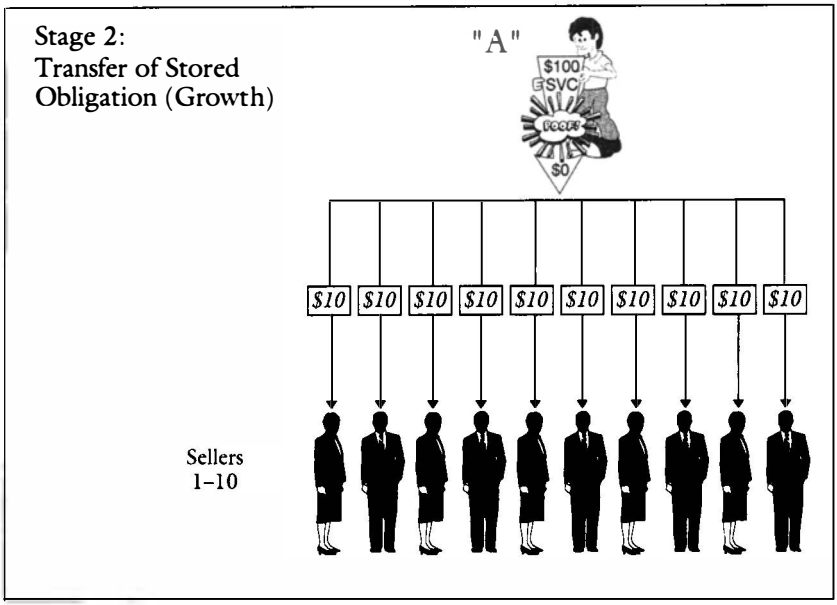
At the time the obligation is created, the issuer may also want to impose certain conditions on users. For example, an issuer may place an expiration date on the storage device. After this date, the obligations on the card or storage device will no longer be transferable. When the storage device expires, however, the status of the obligation is unclear. The holder of an expired storage device may be able to return the device to the issuer and have the obligations on the device transferred to a new device. Issuers may choose to have the storage device expire in order to update security features on the storage device. The issuer may also want to address through contract whether a card, rather than the obligations on the card, can be transferred to someone other than the original purchaser.

The enforceability of these conditions may depend on whether a court views the contract terms as fair to consumers. This is more likely if the contract language is clear and understandable to a purchaser, particularly given the fact that users will not be able to negotiate the contract terms with the issuers.

Transferring the Value

Once an obligation is loaded onto a storage device, the owner will transfer it, or a part of it, to other users. Unlike other payment products, such as a check or cash, the obligation stored on a stored value card can be divided from one obligation into smaller multiple obligations. Suppose, for example, A purchases from a bank a stored value card with $100 of value loaded onto it and then purchases a hat for $10 from ten different hat sellers. After A completes his purchases, the bank's obligation to pay A $100 is replaced with ten obligations of the bank to pay $10 to each seller (see Figure 5). While the bank's liability remains unchanged at $100, its original obligation has grown into ten smaller obligations.

Figure 5: Transfer



When does the issuer's obligation to pay A effectively transfer to a seller? Transfer can be considered complete or effective either when the sender takes all the steps necessary to effect transfer or when the computer technology makes the obligation available for use by the recipient. Under the latter rule, if a person tries to transfer an obligation from one storage device to another, and the second storage device fails during the operation, the transfer is not effective. Making the transfer effective based on when the computer technology makes the obligation available for the recipient's use seems to be the better rule, given that encryption and other security protocols will test each transfer to ensure that it is valid after the steps that initiate the transfer are completed. This is roughly equivalent to the rule for cash and wire transfers in the United States. Payment is effective when cash is received or, with a wire transfer, when a beneficiary bank accepts the transfer.

If the transfer is not valid, the obligation should not become available for the recipient's use. If the effectiveness of transfer relies on computer technology, there is also the possibility that such technology will fail or malfunction. Who then bears the risk of this technological failure? It seems appropriate that damages be apportioned based on whose technology it is that caused the transfer to fail. If a user's equipment fails

because of the user's own fault (that is, not paying an electric bill), then the user should be responsible for whatever damages were sustained. An issuer, on the other hand, would be responsible if its equipment malfunctions (for example, a card reader, through no fault of its user, causes a stored obligation to be erased rather than transferred) or if there is a systemwide defect in the computer technology, such as a computer virus. At the same time, technological failure, such as an electrical blackout, can be an excuse for nonperformance if the technological interruption or failure is beyond the party's control, and the party acted reasonably under the circumstances.

Assuming that the technology works and that the transfer from A to a seller is effective, what happens when the issuer does not pay the seller's claim? Can the seller replevy the hat or require A to pay for the hat again? In other words, has the debt between A and the seller been discharged when the stored obligation is transferred or merely suspended? In the United States, there are different discharge rules, depending on the method of payment. For example, if the transferred obligation is treated like cash, the $10 obligation of A to the seller is discharged when the stored obligation is transferred from A to the seller. If the issuer of the obligation refuses to or cannot pay the seller, then the seller would bear any resulting loss. If the rules governing personal checks apply, however, the $10 obligation between A and the seller is merely suspended when the obligation is transferred until the stored obligation is finally paid by the issuer/obligor.[4] If the issuer fails to honor the stored obligation, the $10 obligation between A and the seller would be restored.

Acceptance of a stored obligation could also be treated like the acceptance of a cashier's check.[5] In this case, upon acceptance, A's $10 debt to a seller would be discharged. Absent endorsement liability on the part of A, the seller could only look to the issuer for payment. Finally, a stored obligation might be deemed to be "goods" under Article 2 of the Uniform Commercial Code (UCC), which governs sales transactions, making the exchange of the obligation for the hat a barter transaction. Under Article 2, if the issuer fails to honor the stored obligation, the seller has the right to replevy the hat from A.[6]

In the United States, arguably, absent an enforceable contract term, a court would apply a rule similar to that governing cashier's checks to this hat purchase example, and, thus, the seller would bear the risk of loss. The cash analogy is not appropriate because there is no question that there is credit risk involved in the hat purchase. The personal check analogy is also imperfect because the seller probably does not regard A as its debtor. Article 2 is limited to the sale of goods and does not apply to choses in action,[7] which is all a stored obligation is. Finally, the applica-

bility of Article 4A of the UCC governing wire transfers seems doubtful because the user of the new payment product is not generally instructing a bank to pay a beneficiary.

Obviously, a rule for determining when transfer is effective is the key to deciding who will ultimately bear the risk of loss. Failing to adopt a finality rule in this context may actually hamper development of stored obligations as a new payments product because users, including merchants, will not be able to judge the risk of using these products and, thus, will be unable to develop mechanisms for reducing this risk. At a minimum, to foster certainty a contract between an issuer and users should include a rule for when transfer is effective.

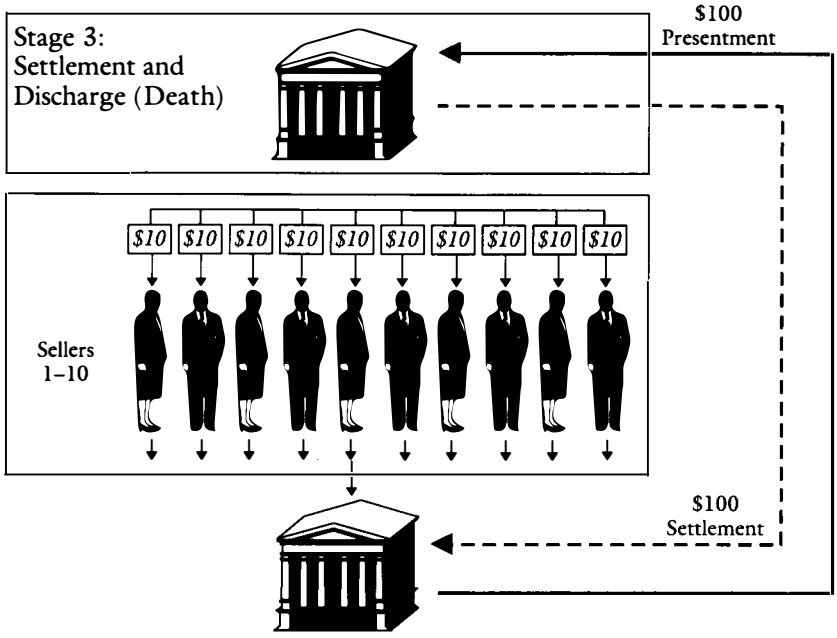
Discharging the Value and Final Settlement

Turning a stored obligation into value might be characterized as "redemption." Redemption of an obligation occurs when the holder of a stored obligation presents the storage device (or its information) to the issuer or the issuer's intermediary and requests money in exchange. In the hat seller example, redemption occurs when sellers one to ten deposit their claims with an intermediary institution that will make presentment on their behalf to the issuer (see Figure 6). At this point in time, A will no longer have any obligations stored on his card. The issuer will most likely respond to the presentment of claims by the sellers by crediting the account of an intermediary on the issuer's books. The intermediary in turn will credit the accounts of sellers one to ten.

During this phase, it will be important for all parties to know the status of the credit provided by the issuer and the intermediary, that is, whether the credit is final or provisional and thus subject to the decision to finally pay. If the credit is provisional, the intermediary may be able to charge back sellers one to ten if, because of insolvency or some other reason, the intermediary does not receive good value from the issuer. At some point, however, these provisional credits will firm up, and the intermediary will no longer be able to charge back the sellers. This is referred to as "receiver finality." If the settlement is final, the intermediary will be left with a loss in the event of an issuer's insolvency because the intermediary will have paid sellers one to ten and received no payment in turn from the issuer.

One problem that may arise when stored obligations are redeemed is that the issuer may learn about an unanticipated increase in the liability side of its balance sheet. This may happen if the technology malfunctions and obligations "spawn," that is, a $10 obligation transfers as a $100 obligation (a problem with divisibility), or if a malefactor discovers a

Figure 6: Settlement and Discharge



method for counterfeiting the issuer's obligations such that it becomes impossible to distinguish an authentically issued obligation from a counterfeit one. Because the asset side of an issuer's balance sheet remains the same, the issuer will likely face two successive problems as these claims are presented for payment: the issuer may experience illiquidity if the number of claimants exceeds all reasonable projections, and, if the spawning or counterfeiting reaches a grand scale, the liquidity problem will degenerate into a solvency problem.

Even without spawning or counterfeiting, an issuer still must be prepared to deal with "term structure" risk, the risk that its liabilities—the debt it owes to users or merchants—will mature at a different time than its assets. Banks in the United States manage this risk in part by borrowing from the Federal Reserve Bank's discount window. Nonbank issuers may, if they choose, manage this risk either by obtaining private insurance or backup lines of credit, or they may be required by law to limit investments to only the most liquid instruments, and maintain reserves.

Another issue is who bears the risk of loss if an issuer becomes insolvent after a stored obligation has been presented to the issuer but before final payment has occurred. The extent of the intermediary's or holder's loss will depend on the manner in which the issuer holds the funds used to purchase the obligations. If the funds are held in an insured account for the benefit of holders of stored obligations, the holders will be guaranteed some amount of money. If the funds are held in a fiduciary or trust account for the benefit of holders of the stored obligations, the issuer's creditors should not be able to reach the funds. Absent an insured or fiduciary account, an intermediary or holder will be a general creditor of an issuer and may not be able to be made whole.

If the intermediary (or redeemer, if the intermediary has charged back the redeemer's account) cannot recover from the insolvent issuer's estate, it will likely look to other entities that can be held accountable for the obligation, including other entities identified on the storage device. In a multiple issuer system, an intermediary may look to any solvent issuer.

Miscellaneous Issues

In addition to the issues identified above, there are a myriad of other unresolved legal issues concerning stored obligations. Some issues that may be of particular concern to central banks are examined below.

Choice of Law

It is anticipated that most new payment products will rely on choice of law provisions in contracts to establish the law that governs the duties and rights of users and issuers. Because there is a possibility that the parties' choice of law may not be given effect, it may be appropriate to have a uniform choice of law rule governing the new payments products, particularly for products that are designed to be used cross border. The rule could allow parties to select the governing law in a contract and could provide a default rule for cases where such a contractual provision does not exist.

Lost or Stolen Obligations

If a stored obligation is lost, stolen, or destroyed, there are two possible analogies that can be used to resolve the question of who bears the risk of loss: the stored obligation can be treated like currency or like a check. When currency is lost, the person who lost it bears the risk of loss and is not able to obtain replacement currency. With a cashier's check, however, the holder who has lost possession can demand payment from

the issuer by filing an affidavit of loss that provides reasonable identification of the check and is received sufficiently in advance of the time when the bank must decide to pay or dishonor.[8] Similarly, with a personal check, the payor is able to stop payment on the lost check if the stop payment order is received by the payor bank in time to act.[9]

There are a number of practical difficulties, however, with adopting the stop payment approach to the new payment products. To stop payment on a lost, stolen, or destroyed obligation, the holder who has suffered the loss must be able to reasonably identify the obligation. Most of the new payment products will not allow a holder to identify uniquely the stored obligation. Even if the obligation is identified uniquely, the issuer may not be able to stop the transfer of the obligation if the issuer is unable to notify others using the products, either at the point of sale or transfer, of the stop payment. Even presuming that the issuer can effect the stop payment, there may be no easy way for the holder that has lost possession of a stored obligation to establish the amount of the issuer's outstanding obligation to the holder at the time the stored obligation was lost.

Foreign Exchange Risk

Stored value products denominated in a foreign currency may also pose additional risks, including the risk that a currency will be devalued or a counterparty will fail. Devaluation risk can be managed, to some degree, through hedging. The risk that a counterparty to a foreign exchange transaction will fail, however, may not be so manageable.

For example, in order to settle an obligation denominated in a foreign currency, the issuer may need to convert the obligation into another currency. In these cases, settlement risk is increased because of the cross-border nature of the settlement. Typically, in cross-border transactions, because of timing differences, one side of the transaction may settle before the other side. During this time, the nonperforming party could fail. If the nonperforming party is in a foreign jurisdiction, the insolvency will be governed by that country's laws. This adds another layer of legal risk to the settlement if the insolvency laws of the foreign country are less favorable to creditors than the insolvency laws in the issuer's country. The risk of devaluation and counterparty failure are normal risks involved in a foreign exchange transaction. There is, however, greater risk that, in the context of stored obligations, the redeemer of the stored obligation—who is the party that will likely bear the risk of loss—will not realize that redemption involves a foreign exchange transaction or, if the redeemer is a consumer, may not understand these special settlement risks.

Conclusion

Stored value products are being tested in different markets around the world from small towns to the major financial centers in Asia, the United States, and the United Kingdom. As these products become more widely used, many issues raised in this chapter may be resolved through contract or customary use, while other issues may warrant regulatory intervention. As a new retail payments system, stored value products deserve careful attention to ensure that appropriate rules are adopted. Central banks can help foster the development of such rules, thereby permitting these products to act as an efficient payment mechanism for consumers without unnecessary or uncontrollable risk.

COMMENT

GREGOR C. HEINRICH

Electronic Money, Stored Value Cards, and Internet Payments: Legal and Policy Issues

Central banks show an interest in electronic money or e-money, cybercash, and electronic purses or e-purses, because these new developments may have a bearing on some of their functions. Lawyers are interested in these developments because they have to know whether and how existing legal rules can be applied to them, whether and how the rules need to be adapted, and whether new rules need to be drawn up. Central bank lawyers involved in areas such as payment system oversight, banking supervision, and perhaps even consumer protection or fraud prevention are in positions where they may need to offer guidance to governmental and institutional policymakers. In addition, lawyers, as private individuals and consumers, may soon be active users of e-money. Therefore, their interest in new payment instruments is not merely academic: it is also practical.

A market exists for e-money schemes in their various forms. There are "closed-loop schemes," in which the e-money can be "spent" only once before it has to be redeemed by the issuing institution, and "open-loop schemes," which allow for "purse-to-purse" transactions.[1] Both users (that is, consumers) and issuers (for example, banks and card organizations) have an interest in this new market. The potential user base is growing, and e-money issuers see a huge profit potential in what could be a major financial innovation in the retail market.

A potential user base already exists in many countries, on the one hand among users of payment cards, on the other hand among users of personal computers (PCs), and, of course, a combination of the two is also conceivable. Many consumers today feel comfortable with using some form of plastic card for payments. The use of magnetic strips and, most recently, the advent of "intelligent chips" incorporated into a card have greatly increased the security and use potential of such plastic cards. The world market for smart cards is growing rapidly, as more home computers are being sold and as more PC users are linking up to communication networks. One forecaster expects it to reach four billion potential card users by the year 2000.[2]

In the future of banking, it is therefore assumed that most customers will have access to the "information super highway," and it is said that smart

card interfaces in PCs (a box linked to the PC so that smart cards can be read as they are now read by automatic teller machines) will become as standard as floppy disks. One of the predicted uses of an Internet e-money scheme is for payment of goods and services obtained or ordered through computer communication links (for example, the World Wide Web). Because banknotes and coins cannot be pushed through the telephone line and because transaction costs for the use of checks or credit cards in small value transactions may be just too high, there is an increasing need for these new payment instruments. In addition, there is a practical use for current e-purse schemes at the retail level too, with traditional low-value cash payments (for example, for parking meters, public transportation, kiosk purchases, taxis, and vending machines). In fact, most smart card developers aim at a market for transactions of less than $20.

How does the intended use of e-money as a cash replacement compare with the use of cash, both banknotes and coins, usually issued by the central bank; debit cards, which use electronic funds transfer for point-of-sale purchases; checks; and credit cards? One distinction is that checks, debit cards, and credit cards involve an instruction to a mutually trusted third party to make a payment on behalf of the purchaser, whereas cash may be handed over directly from the purchaser to the merchant.

By examining the characteristics of cash, one can notice that many proposed e-money schemes, at the least, try to emulate the functions and use of cash. Cash is a standard product and is therefore easily recognized and identified. It is risk free in the sense that the central bank gives it full backing. (Of course, cash can be risky to hold in that it can be lost or stolen, and there may be a risk of counterfeit.) It is fully negotiable. Possession of cash is ordinarily sufficient to establish a right of use, and it simply can be handed to someone else to execute a payment. Use of cash is anonymous and not directly traceable. Cash is convenient and efficient for making small payments. It is valid consideration in almost all places and circumstances, and, except where forgery is suspected, its status cannot be questioned. It is because of these attributes that cash is generally accepted and popular. Generally, in industrial countries cash transactions account for up to 80 percent or more of the volume of all payments,[3] even though the total value of all cash transactions may be relatively small in many countries (compared, for instance, with cashless payments and settlement schemes). Even if cash is generally accepted at the consumer level, it may nevertheless, in the eyes of intermediaries, not always be the preferred method of payment, because use of cash involves handling, storage, and security costs, which may not arise to the same extent with other payment methods.

Consequently, it would be valuable if the convenience of cash could be combined with comparatively low-cost, high-tech mechanisms. E-money

may therefore be of interest not only to consumers but also to the designers and operators of e-money schemes. As companies, the latter are not interested in the actual cash payment but in benefiting from the considerable float. Float makes possible the interest revenue for the issuer on funds received from the public in exchange for the e-money during the period of time between receipt of funds and presentation of e-money for redemption. By way of example, this phenomenon can be observed with simple prepaid cards such as phone cards, where the telephone company may benefit from funds before the prepaid call is made. In addition, e-money designers hope for additional revenue in that cards may be "branded" to show the logo of a commercial company. Revenue may also result through the use of loyalty schemes (such as the accumulation of frequent flyer miles) by the intelligent chip. Such additional revenue may even be larger than the revenue from float and may thus offset to a large extent the operating costs of e-money schemes.

If e-money is to replace physical cash and e-money issuers are to benefit from the float, then those who previously benefited from the float on physical cash may lose revenue. This is precisely the concern that some central banks have voiced with regard to their "seigniorage" income.[4] Seigniorage is the income a central bank (and the government, if the latter receives a share in the profits of its central bank) receives as a result of its monopoly on the issuing of banknotes.[5] This is one of the reasons why the recent development of e-money products and their potential effect on policy issues are currently being discussed at the Bank for International Settlements. The main committee in charge of these discussions is the Committee on Payment and Settlement Systems (CPSS), a forum in which experts from the central banks of the Group of Ten countries convene in order to discuss topics of common interest.[6]

The term "electronic money" is used by the CPSS to cover a number of new or proposed payment products generally designed for retail use, including both card schemes (so-called electronic purses or multipurpose prepaid cards) and computer network or software-based schemes (in particular, various proposals to offer nonstandard payment services on computer networks such as the Internet). In November 1995, the central bank governors of the Group of Ten countries commissioned studies on the monetary policy and seigniorage implications of the development of electronic money, the security aspects of the schemes, the challenges they could pose to law enforcement, the legal and contractual framework for the development of the new services, and issues relating to the different potential categories of providers of such new products. The studies are being undertaken by several special task forces. In addition, a group of legal experts from these central banks is examining legal issues related to e-money.

Although there may be a number of descriptive articles regarding the various experimental e-money schemes, there is still little literature on the legal issues,[7] and it appears that no e-money scheme has yet been tested in a court. In addition, the market is still evolving. It is difficult to assess whether one or another scheme will find wide acceptance with users and merchants. Furthermore, without more information, it is difficult to judge what effect schemes may have on the safety and soundness of the financial system and on the individual consumer.

Lawyers will have to arrive at an opinion as to whether e-money schemes—like any other arrangement for making monetary payments—have satisfactory legal underpinnings. It is important that all the parties to a payment involving e-money (that is, the payer/user; the recipient/merchant; and any other party, such as issuers, banks, or clearing systems that may be involved as intermediaries) understand their rights and obligations, as well as any risks that they may face. Further study of the aspects of e-money will aid in the development of applicable law.

Issues

The following issues are worthy of consideration:

- Why are banknotes and coins legal tender? Can e-money be legal tender? If not, what are the consequences?
- If there is a market for instruments replacing banknotes and cash, should this market be for central banks, commercial banks, or private companies (nonbanks)? Are there legal rules that would allow or prevent the issuance of e-money by any of the above?
- Why are banknotes "negotiable instruments" under some laws? Is it essential for e-money to have a similar status? Does e-money have this status under existing legislation?
- Some central banks have suggested that replacing traditional cash with e-money would deprive governments and central banks of their seigniorage revenues. Is this correct? Are there laws allocating seigniorage to government authorities and central banks? What types of legal mechanisms may be conceived for recovering lost seigniorage, if any, in connection with e-money schemes?
- Could retail banks still afford to handle cash transactions if e-money becomes popular? Should central banks intervene to correct any market distortion, and how can this be done? Is there a danger that calls for a "right to a bank account" might one day be modified to a "right to use physical cash"?

- Use of a computer can be recorded, and transaction data can be stored for later analysis. Use of e-money schemes involving computers may therefore create "usage patterns" of individuals or groups of users. Should the storage, use, or dissemination of such information be protected? Do current rules offer satisfactory protection?
- Counterfeiting banknotes and coins, as well as making use of such counterfeited instruments, is an offense punishable under criminal law. What similar offenses might apply to e-money schemes? Could existing anticounterfeiting rules apply to counterfeiting e-money? If not, which other rules of national legislation may help to prevent fraud?
- Where a country has exchange controls and/or reporting requirements for foreign exchange transactions, how could those rules apply to e-money?
- Encryption standards and cryptographic mechanisms in both card-based and network-based payment schemes provide an apparently effective protection against fraud, allow for safer transmission of information, and thus increase the reliability of a scheme and make it more attractive to the user. Should governments, central banks, commercial banks, and/or other entities (for example, trustees and certification authorities) retain control of such mechanisms? Are there any legal methods to enhance or prevent such control?
- In many countries, a parallel economy exists in that not all cash transactions pass through the books of merchants that provide goods or services. This may reduce the state's tax revenues and may also distort economic statistics. What effect might e-money have on such phenomena?

COMMENT

ROBERT G. BALLEN

Electronic cash, or e-cash, and stored value cards raise a number of important issues for central banks and related government regulatory entities around the world, including issues related to consumer protection, central bank reserve requirements, deposit insurance, money laundering, commercial and payment law, counterfeiting and other fraud, privacy, and safety and soundness.

Hypotheticals

Three hypotheticals are presented below by way of illustration. Although these hypotheticals involve stored value cards, they are equally applicable to e-cash type arrangements.

Hypothetical Number 1: Lost or Stolen Stored Value Cards

Charles Consumer purchases with cash from Issuing Bank stored value card Number 1 containing $100 of value. Charles Consumer also purchases from Issuing Bank, using his credit card, stored value card Number 2 containing $1,000 of value. Charles Consumer walks out of Issuing Bank and is robbed by Thomas Thief who steals Charles Consumer's stored value cards. Charles Consumer runs back into Issuing Bank and reports the robbery of the stored value cards.

- Should Charles Consumer be able to obtain a refund from Issuing Bank of all or a portion of the value on either stored value card Number 1 or stored value card Number 2?
- Should Issuing Bank be required to have the ability to block transactions with respect to either stored value card Number 1 or stored value card Number 2?
- If Charles Consumer is refunded the value on either of the stolen stored value cards and transactions with the stolen cards are not blocked, who bears the loss from these transactions: Issuing Bank, other financial institutions seeking settlement from Issuing Bank on behalf of their merchant customers, or a merchant that accepts the stored value from either Thomas Thief or from another person that took the stored value from Thomas Thief in exchange for goods and services?

Hypothetical Number 2: Terminal Malfunction

Charlotte Consumer purchases with cash from Issuing Bank stored value card Number 3 containing $100 of value. Charlotte Consumer also purchases from Issuing Bank, using her credit card, stored value card Number 4 containing $1,000 of value. Later that day, Charlotte Consumer desires to purchase $50 in groceries from Mike Merchant. Charlotte Consumer puts stored value card Number 3 (containing $100 of value) into the terminal at Mike Merchant's cashier checkout. The terminal does not appear to register the transaction. Charlotte Consumer then puts stored value card Number 4 (containing $1,000 of value) into the terminal, and this transaction appears to register. Charlotte Consumer leaves Mike Merchant with her $50 of groceries. Because of a further terminal malfunction, the terminal does not register that any value was transferred to Mike Merchant. Several days later, when Charlotte Consumer next uses stored value card Number 3, she realizes that the $50 had been deducted from it by the terminal of Mike Merchant. Moreover, several days after that, when Charlotte Consumer next uses stored value card Number 4, she realizes that the terminal has deducted $500 in value (rather than $50) from it as well.

- Has Charlotte Consumer's obligation to Mike Merchant for the groceries she purchased been discharged when the stored value was deducted from Charlotte Consumer's stored value card? Or, does Charlotte Consumer have a continuing obligation to Mike Merchant until he receives final settlement from Issuing Bank?

- Should Charlotte Consumer be refunded the debits to either stored value card Number 3 or Number 4 in excess of one $50 debit for the groceries she purchased? If so, who should be responsible for that refund: Issuing Bank or Mike Merchant? If Terminal Bank leases or operates the terminal at Mike Merchant's store, should Terminal Bank be responsible for the refund? What if the terminal is owned by a nonbank processor instead of Terminal Bank?

- If the terminal at Mike Merchant's store does not provide or maintain written receipts or other documentation, how will the transactions in question be reconstructed?

Hypothetical Number 3: Issuing Bank Insolvency

Issuing Bank is the issuer of a large number of stored value cards. As a result of unsafe and unsound practices that are unrelated to its stored value card program, Issuing Bank becomes insolvent and is taken over by the government authorities. At that time, there is $1.5 billion in value outstanding on stored value cards issued by Issuing Bank.

- Is the government or other deposit insurance entity, as receiver of Issuing Bank, obligated to reimburse holders of stored value cards issued by Issuing Bank? Is the government or other deposit insurance entity obligated to reimburse merchants who have sold goods or services to holders of stored value cards issued by Issuing Bank? Should it matter whether the merchant received this value before or after the insolvency of Issuing Bank?
- Should the result be different if the issuer of the stored value cards is not a bank?
- To the extent that stored value obligations become a substitute for cash in a nation's economy, what steps should the government take for ensuring confidence in a stored value system?

Analysis

Hypothetical Number 1: Lost or Stolen Stored Value Cards

Because stored value cards represent a new payment instrument that has not been addressed fully by U.S. payment laws or U.S. bank regulators, there is no definitive answer to Hypothetical Number 1. Instead, identified below are various factors and policy considerations that may affect the ultimate resolution of the hypothetical.

The relationship between Charles Consumer and Issuing Bank may be governed solely by the terms and conditions of the agreement between Charles Consumer and Issuing Bank. If so, Issuing Bank may be able to hold Charles Consumer fully responsible for a stolen card, or Issuing Bank may agree, under the terms and conditions, to refund some or all of Charles Consumer's money in order to encourage consumers to hold the stored value cards as a cash substitute. This would be similar to the refund that is available to consumers for lost or stolen traveler's checks from the issuers of the traveler's checks. Alternatively, it may be determined by statute or regulation that, as a policy matter, consumers should be protected against the risk of loss from stolen stored value cards and that Issuing Bank should bear some or all of the risk of loss. This sort of consumer protection would be analogous to the limitations under U.S. federal law on consumer liability for lost or stolen credit cards and automatic teller machine (ATM) cards.[1] It is unclear whether placing some or all of the risk of loss on the issuers of stored value cards would limit the willingness of at least certain issuers to offer these products to consumers.

Whether Issuing Bank should be required to have the ability to block transactions with a stored value card has a number of important implications. First, not all stored value systems under development include the

technological capability to block transactions. Indeed, the costs associated with such capacity may preclude on economic grounds the use of such systems for certain types of transactions. Second, requiring Issuing Bank to block transactions necessitates that it track or have the capacity to track individual card transactions and link them to a particular card or person. This may have the unintended (and undesired) result that Issuing Bank will develop a large database of consumer transactions (such as merchant locations, amounts, and dates). This type of database could raise personal privacy concerns with the users of the stored value cards.[2]

Assuming that Charles Consumer has been refunded his value, the question of which party in the payments process bears the ultimate risk of loss may be resolved in a number of ways. First, to encourage the widespread acceptance of a particular stored value system, the institutions that develop the system (which may be Issuing Bank and other depository institutions in an association of member banks) may decide that they will accept responsibility as a group for liability arising from the use of lost or stolen cards at merchant locations. Alternatively, Issuing Bank may agree to provide indemnification only to those merchants (and their collecting banks) that have followed certain security procedures when accepting stored value cards. These security procedures, such as the use of an electronic negative file, would cut down on losses attributable to stolen stored value cards. Finally, it is possible that a stored value card system could adopt an operating rule (analogous to rules under U.S. check laws) that the party that first deals with the thief (in this case, the merchant) bears the risk of loss. The allocation of this loss likely will be governed by the Issuing Bank contract, terms and conditions, system rules, or other agreements governing the stored value card.

Hypothetical Number 2: Terminal Malfunction

Again, because stored value cards represent a new payment instrument that has not been addressed fully by U.S. payment laws or U.S. bank regulators, there is no definitive answer to Hypothetical Number 2. Instead, identified below are various factors and policy considerations that may affect the ultimate resolution of the hypothetical.

The issue of discharge of the underlying obligation highlights one of the significant differences between the stored value card and U.S. currency or other legal tender. Under U.S. law, the payment of U.S. currency (legal tender) by a consumer to a merchant in the amount of the obligation owed, as a matter of law, fully satisfies and discharges the obligation at the time the currency is transferred.[3] The fact that the merchant subsequently loses the U.S. currency, or the U.S. currency is destroyed (such as in a fire), does not change the legal status of the consumer's full discharge of the underlying obligation. By comparison, stored value does

not meet the definition of U.S. currency or other legal tender because it is not issued by the U.S. Treasury Department and/or is not backed by the U.S. government. Because it is not U.S. currency, a transaction with stored value does not automatically, by operation of law, discharge Charlotte Consumer's obligation to Mike Merchant.

It is likely that the operating rules that will be developed for stored value systems will address the issue of discharge and may well adopt a rule similar to the legal tender rule. Such a systemwide discharge rule will give the consumer the assurance that a merchant will not be able to come after him or her at a later date and demand payment for a failed stored value transaction. It is also possible that commercial law will be developed to address this issue of discharge, either in the absence of an applicable system operating rule or perhaps in spite of a contrary rule.

Rules regarding responsibility for the failure of a particular stored value transaction will likely be addressed in the operating rules of the stored value systems. Given that stored value systems, at least in the United States, represent a new payment system, there may be pressure on the issuing institutions to indemnify merchants for losses caused by malfunctioning technology in order to encourage merchants to accept these new payment products.

It may be possible to reconstruct transactions with a stored value card using a record of transactions that is stored on the stored value card itself or alternatively in the terminal or at a central database. Depending on the applicable technology, it also may be possible to reconstruct transactions (or at least the amount of the lost stored value) from the record of "unredeemed" value held at the issuing institution that corresponds to the outstanding stored value on the stored value card in question.

Hypothetical Number 3: Issuing Bank Insolvency

As previously noted, because stored value cards represent a new payment instrument that has not been addressed fully by U.S. payment laws or U.S. bank regulators, there is no definitive answer to Hypothetical Number 3. Again, identified below are various factors and policy considerations that may influence the ultimate resolution of the hypothetical.

The question of deposit insurance for stored value obligations is an issue to be determined by the applicable government agency. As in the United States, a particular government may decide that only certain stored value systems qualify for deposit insurance protection, while others do not. For example, a government may require that the issuers of stored value cards maintain certain types of records on the individual holders of the stored value cards in order to qualify for deposit insurance. These records would allow the insurer to determine which of those hold-

ers of stored value cards had valid claims against the failed issuer and which did not.

To the extent that stored value systems have replaced cash in a nation's economy, there would be a strong policy incentive for the government to insure the outstanding stored value in order to prevent a loss of confidence in the entire payment system resulting from the failure of a single issuing institution.

Chapter 7

Checks and Check Collection: A Comparison Between the Common Law and Geneva Systems

ANTHONY G. GUEST[1]

This chapter sets out some comparisons between the common law and Geneva systems relating to the legal incidents of checks and their collection.

Special Features of a Check

Banks

Checks are associated with banks. This is clear from the definition in Section 73 of the Bills of Exchange Act (BEA),[2] "[a] cheque is a bill of exchange drawn on a banker payable on demand" and in Section 3-104(f) of the Uniform Commercial Code (UCC)[3] where a check is defined to mean "(i) a draft, other than a documentary draft, payable on demand and drawn on a bank or (ii) a cashier's check or teller's check." A "draft" is the term used by the UCC to describe a bill of exchange.[4] A "cashier's check" is the American term for a banker's draft,[5] and a "teller's check" means "a draft drawn by a bank (i) on another bank, or (ii) payable at or through a bank."[6] Although, under the Geneva system,[7] a check is not a bill of exchange with special features but an instrument in its own right, Article 3 of the Uniform Law on Cheques (ULC)[8] requires that a check be drawn on a banker, but in addition prescribes that it has to be "drawn on a banker holding funds at the disposal of the drawer and in conformity with an agreement, express or implied, whereby the drawer is entitled to dispose of those funds by cheque." It is generally accepted that the funds so held need not be money deposited by the drawer with the bank but may also comprise a line of credit or overdraft granted to the drawer by the bank.

Article 3 of the ULC includes a proviso under which the noncompliance with these provisions does not invalidate the check. However, under Article 4 of Annex II of the Convention Providing a Uniform Law for Cheques,[9] each state was granted the right to determine "that instruments drawn on persons other than bankers or persons or institutions assimilated by law to bankers" are not to be valid as checks. This reservation has been used by a number of states.[10]

What Is a Bank?

Determining what is a bank is a difficulty that arises in a number of contexts. English law has attempted to solve the problem by providing in Section 2 of the BEA that the word "'[b]anker' includes a body of persons whether incorporated or not who carry on the business of banking." However, this only takes one back to what is the "business of banking." Paradoxically, the case law on this subject then refers back to the requirement that one of the main features of the business of banking is the payment and collection of checks. To some extent, the English courts have attempted to sidestep this issue by holding that an institution may be considered a bank, regardless of the precise nature of its business, if it has gained a general reputation as a bank.[11] A marginally better definition is found in Section 4-105(1) of the UCC: "'Bank' means a person engaged in the business of banking, including a savings bank, savings and loan association, credit union, or trust company." The vague reference to "banking business" is thus augmented by the express inclusion of certain types of institutions.

The ULC seeks to solve this difficulty in a different way. First, Article 54 provides that "the word 'banker' includes the persons or institutions assimilated by the law to bankers." Second, under Article 4 of Annex II of the Convention Providing a Uniform Law for Cheques, which incorporates the reservations available to the contracting states, a state is granted the right to embody in its national law the provisions of Article 3 of the ULC, requiring that a check be drawn on a banker, "in the terms best suited" to local needs. So, for example, in Belgium, France, and Germany, checks may be drawn on registered banks and on certain other specified institutions pursuant to the domestic law.

Tenor

A check issued in a common law system is, by definition, payable on demand.[12] The position is the same under Article 28 of the ULC, under which a check is so payable, and "[a]ny contrary stipulation shall be disregarded." These latter words lead to a difference between the Anglo-American and Geneva systems. Under the common law, an instrument drawn on a banker[13] and payable other than "at sight" or "on demand" is not a check but a bill of exchange. Under the ULC, if the instrument is defined in its body as a "check," any attempt to make it payable other than at sight is ineffective and does not alter its status as a check.

Postdated Checks

Under the common law, a drawer may postdate a check issued by him or her, with the object of ensuring that it will not be paid if presented for

payment before the date written on the check.[14] In English law, a postdated check is valid and negotiable (although there is some dispute as to whether it is in fact a check, and not a bill of exchange or promissory note, before the date written on it has arrived). This is expressly provided in Section 13(2) of the BEA, which states that a bill is not invalid by reason only of its being postdated or antedated. Moreover, a transferee can become a holder in due course even where he or she takes the check prior to the purported date of drawing written on the check. A bank in the United Kingdom will, in practice, refuse to honor a check presented before the date written on it, and there is authority for the view that, if it does so, it is not entitled to debit the drawer's account until that date has arrived. The drawer is entitled to countermand payment of the check at any time before it is presented for payment at or after the date written on it has arrived. Under Section 3-113(a) of the UCC, a check may similarly be postdated and it is not payable before the date of the instrument. However, under Section 4-401(c), a bank may charge against the account of a customer a check that is properly payable from the account, even though payment was made before the date of the check, unless "the customer has given notice to the bank of the postdating describing the check with reasonable certainty."

The approach of the ULC is very different. Under Article 28, "[a] cheque presented for payment before the date stated as the date of issue is payable on the day of presentment." It is also accepted that, if a postdated check is dishonored upon such early presentment, the holder acquires his usual right of recourse.

Assignment of Funds

In English law, the drawing of a check does not give rise to an assignment by the drawer to the payee or holder of funds held for the drawer by the drawee bank.[15] The same is true under Section 3-408 of the UCC. Moreover, in the common law systems, there is, of course, no express provision under which the check has to be drawn against funds available to the drawer with the drawee bank.

The position may differ in the case of some countries that have adopted the ULC. According to Article 3, a check must be drawn against funds available to the drawer with the drawee. It was left to each country to determine the moment at which the drawer must have funds available with the drawee.[16] While most countries have left Article 3 unchanged, some countries—France,[17] for example—have provided that funds must be available at the time the check is drawn, while others have provided that cover need be available only when the check is presented for payment. Article 3 does not, of course, confer any rights to the cover on the

payee or holder.[18] However, rights to the cover may be acquired outside the ULC. For example, in France, where the principle of *provision* originates, once the check is endorsed the holder has right to the cover.[19] In other ULC states, such as Germany,[20] the payee or holder acquires no direct rights to the funds available to the drawer with the drawee.

Transferability

In English law, as in the case of bills, a check may contain words prohibiting transfer or indicating an intention that it should not be transferable, in which case it is valid between the parties thereto but is not negotiable.[21] At one time, this was achieved by writing the words "not transferable" on the check or, more often, "pay X only." In 1992, however, the BEA was amended by the Cheques Act, 1992, to create a new method of rendering checks nontransferable by the addition of the words "a/c Payee."[22] Most domestic checks are now preprinted with these words, so that the check has become in effect a mere payment order and ceased to be a negotiable instrument. This has caused considerable difficulties for "unbanked payees," that is, payees who do not themselves have a bank account but who previously were able to get a friend or shopkeeper to cash the check for them.

Article 14 of the ULC also permits the restriction of the transferability of a check. "A cheque made payable to a specified person, in which the words 'not to order' or any equivalent expression have been inserted, can only be transferred according to the form and with the effects of an ordinary assignment."[23] Further, Article 7 of Annex II of the Convention Providing a Uniform Law for Cheques permits a country to reserve "the right to prescribe, as regards cheques payable in [its] territory, and marked 'not transferable,' that a cheque of this description may be paid only to the holder who has received it thus marked." Some countries have used this reservation as, for example, Italy, where such a check has to be paid over the counter to the specified payee or to the credit of the specified payee's account with a collecting bank nominated by him or her.

In contrast, Australia has, with the introduction in 1986 of a form of nontransferable payment order, invalidated clauses or notations that seek to destroy the transferability of a check. In the United States, too, checks are expressly excluded from the ambit of UCC Section 3-104(d), which makes provision for the drawing of nonnegotiable bills and notes.

Certification

The duty that the drawee bank owes to the drawer does not arise under the law of negotiable instruments. It is the product of the contractual

relationship between the bank and the drawer, its customer. The drawing of a check creates no contract between the drawee bank and the holder. The question, however, arises whether the holder can acquire direct rights against the drawee bank because the bank has accepted the check or done some other act, such as marking the check "good for payment."

In English law, generally a check cannot be accepted. So far as certification or the marking of a check as "good for payment" is concerned, the leading authority (*Bank of Baroda v. Punjab National Bank Ltd.*)[24] indicates that a certification does not in itself give the holder any right to sue the certifying banker. It has, however, been suggested that the banker may be estopped from pleading that the drawer's account did not have a credit balance sufficient to meet the check at the date of the certification. However, it does not constitute a promise or guarantee by the drawee bank that the check will be paid when presented. Nor does certification entitle the bank to earmark any amount standing to the credit of the drawer's account for the purpose of meeting this check, and the bank will be compelled to pay any check presented for payment prior to the presentation of the certified check and to carry out any instruction by the drawer that countermands (stops) payment of the certified check. In practice, therefore, English banks and those in most Commonwealth countries do not certify or mark checks.

The position is otherwise in the United States. Under Section 3-409(d) of the UCC a "'[c]ertified check' means a check accepted by the bank on which it is drawn." Acceptance can be made either in the same manner, as in the case of a bill of exchange, or by a "writing on the check which indicates that the check is certified."[25] The drawee bank is not under any "obligation to certify the check, and refusal to certify is not dishonor of the check."[26] Under Section 4-303(a), once a check has been certified or accepted, the drawer loses his or her right to countermand payment.

The ULC draws a distinction between acceptance and certification. Under Article 4, a check cannot be accepted, and a statement of acceptance on a check is to be disregarded. To preclude indirect acceptance by the drawee, Article 15 provides that an endorsement by the drawee is null and void. However, Article 6 of Annex II of the Convention Providing a Uniform Law for Cheques states that a country "may provide that a drawee may write on the cheque a statement of certification, confirmation, visa, or other equivalent declaration, provided that such declaration shall not operate as an acceptance, and may also determine the legal effects thereof." This reservation has been used by a number of countries to permit the "visa" or confirmation of checks by the drawee bank, although they differ, in particular, as to whether (i) the bank is or is not obliged to give such confirma-

tion at the holder's request; (ii) such a confirmation constitutes merely an assurance that cover is available at that time or that the check will be paid on presentment; (iii) cover is or is not then earmarked for the holder until the expiry of the time allowed for presentment; and (iv) the confirmation discharges the drawer from liability to the holder.

The natural desire of traders and others to ensure that checks taken by them in payment will be satisfied on presentment has, of course, been met by the more recent development of the check card or "check guarantee card." The binding effect of the bank's promise to the trader or other recipient of the check that the check will be paid has been recognized in both the common law and civil law systems. The exact nature of the promise given by the bank has to be ascertained from the terms of the undertaking given by the bank. In a recent English case, *First Sport Ltd. v. Barclays Bank plc.*,[27] the Court of Appeal held that the terms of the bank's undertaking were not sufficiently unambiguous to permit the bank from disclaiming liability when the customer's signature on the check resembled that on the card but was in fact a forgery. Apparently, no attempt has been made by British banks to tighten up their conditions so as to entitle them to refuse to pay the holder where the customer's signature appears on its face to resemble that on the card but is nevertheless a forgery—no doubt because such an amendment would greatly reduce the efficacy of bank guarantee cards. It is also generally accepted that the issue of a check by the drawer supported by such a card takes away any right that he or she may have to countermand payment of the check.

Presentment for Payment

The BEA does not set out time limits within which a check must be presented for payment. Nevertheless, British banks will normally refuse to honor a check presented after six months from its date of issue (unless specifically instructed to do so by the drawer), and there is little doubt that this time limit is now sanctioned by usage and banking practice. (However, Section 74(1) of the BEA to some extent casts upon the holder of a check that is not presented for payment "within a reasonable time" of its issue certain risks associated with the delay in the event of the insolvency of the drawee bank.) In the United States, Section 4-404 of the UCC specifically allows the dishonor of a check that is presented more than six months after its date, although the bank is entitled to debit the customer's account with the amount of the stale check provided that it has paid it in good faith. Section 4-404 does not apply to certified checks.

A very different system is provided for in the ULC. Under Article 29, "[a] cheque payable in the country in which it was issued must be pre-

sented for payment within eight days" from the date stated on the check as the date of issue. Where a check is issued in a country other than that in which it is payable, it must be presented "within a period of twenty days or of seventy days, according as to whether the place of issue and the place of payment are situated respectively in the same continent or in different continents,"[28] and countries bordering on the Mediterranean are to be regarded as in the same continent.[29] However, under Article 14 of Annex II to the Convention Providing a Uniform Law for Cheques, a state adopting this reservation may alter the prescribed time limits, and it is perhaps only a minority of states that have not done so.

Under Article 31 of the ULC, "[p]resentment of a cheque at a clearinghouse is equivalent to presentment for payment." However, the most recent authority indicates that, in English law, this is not the case and that presentment for payment takes place only when the check is presented for payment at the branch address of the bank stated on the check, where the effective banking decision is taken whether to dishonor the check or not.[30]

Countermand of Payment

Under Section 75(1) of the BEA, the duty and authority of the drawee bank to pay a check drawn on it is determined by countermand of payment by its customer. The countermand may be communicated at any time prior to its payment by the bank on presentment. A similar situation prevails under Section 4–303 of the UCC, although certain events prior to actual payment may preclude countermand.

In contrast, Article 32 of the ULC provides that "[t]he countermand of a cheque only takes effect after the expiration of the limit of time for presentment" and that, "[i]f a cheque has not been countermanded, the drawee may pay it even after the expiration of the time-limit." However, Article 16 of Annex II to the Convention Providing a Uniform Law for Cheques permits states to allow countermand of a check even before the expiration of the time limit or to prohibit countermand even after the expiration of the time limit. It also permits a state to "determine the measures to be taken in the case of the loss or theft of a cheque" and to "regulate the legal consequences thereof."[31]

Death of Drawer

Under Section 75(2) of the BEA, the bank's duty and authority to pay a check is determined by notice of the customer's death. The position is similar under Section 4-405 of the UCC, except that the bank has authority to pay a check within 10 days following the customer's death, even if it has notice thereof, unless ordered to stop payment by a person

having an interest in the account. However, under Article 33 of the ULC, neither the death of the drawer nor his incapacity taking place after the issue of the check is to have any effect as regards the check.

Crossings

The practice of crossing checks is not found in the United States, although U.S. banks will apparently accept for collection crossed checks drawn on a foreign bank. Both the BEA and ULC provide for crossings and with approximately similar effects. Most Geneva system countries permit crossings, although Germany and Austria (acting under a reservation in Article 18 of Annex II of the Convention Providing a Uniform Law for Cheques) recognize in their national laws only checks "payable in account," while nevertheless treating such checks as crossed checks issued abroad but payable in those countries. It is almost universal practice in the United Kingdom for banks to issue to their customers only checks with crossings pre-printed on them. If the customer/drawer wishes for some reason to issue an uncrossed check, then he or she "opens the crossing" by writing across it the words "pay cash" and signing the alteration.

Other Annotations on Checks

BEA: Not Negotiable

Under Section 81 of the BEA, "where a person takes a crossed cheque which bears on it the words 'not negotiable,' he or she shall not have and shall not be capable of giving a better title to the cheque than that which the person from whom he or she took it had." The check therefore remains transferable, but the holder takes the check at his or her own risk and will be subject to all the defenses available against prior parties even though he or she acquires the check in good faith, for value, and without notice of the defective title of the transferor. This Section will also affect the original payee of a check who is affected by fraud.

BEA: a/c Payee

As previously mentioned, the original effect of such a notation on a crossed check was not to make the check nontransferable but merely to act as a warning to the collecting bank that the check should not be collected for a person other than the specified payee. However, the law has been changed in the United Kingdom by the enactment of the Cheques Act, 1992, which inserted a new Section 81A in the BEA.[32] Under Section 81A(1), "[w]here a cheque is crossed and bears across its face the words 'account payee' or 'a/c payee,' either with or without the word 'only,' the cheque shall not be transferable, but shall only be valid

between the parties." Since the majority of checks in the United Kingdom are now preprinted with these words on them, it follows that the check is now reduced to the status of a payment order and is not a negotiable instrument at all. A similar provision has been enacted in Singapore,[33] but, so far, other countries with systems derived from the BEA have not followed suit.

UCC: Checks Payable Through a Bank

Under Section 4-106(a) of the UCC, if a check is "payable through" a bank identified in the item, (i) the check designates the bank as a collecting bank and does not by itself authorize the bank to pay the check, and (ii) the check may be presented for payment only by or through the bank. This annotation therefore has a similar effect to a special crossing under the BEA and ULC.

ULC: Checks Payable in Account

Under Article 39 of the ULC, "[t]he drawer or the holder of a cheque may forbid its payment in cash by writing transversally across the face of the cheque the words 'payable in account' (*'à porter en compte'*) or a similar expression." In such a case, the check can only be settled by the drawee by means of book entry (that is, credit in account, transfer from one account to another, setoff, or clearinghouse settlement). Settlement by book entry is equivalent to payment. The effect of these words is, therefore, similar to that of a general crossing. It may, however, be the case that, where the drawer and the holder of a check bearing a general crossing maintain their accounts with the same branch of the drawee bank, then Article 38 may allow payment of the item in cash. However, a check marked "payable in account" has to be discharged by a book entry even in that case (although the holder or payee is entitled to withdraw funds from his or her account immediately once they have been effectively credited).

Bankers' Drafts

Under Section 3(1) of the BEA, a bill of exchange (including a check) must be "addressed by one person to another." A check drawn by a bank on itself (whether on its head office or on another branch of the same bank) is therefore not a check. However, under Section 5(2) of the BEA, the holder may treat the instrument at his option either as a bill of exchange or as a promissory note. The instrument is therefore negotiable, and the holder may enforce it against the bank as drawer. Further, the protection afforded in the United Kingdom by the Cheques Act, 1957, to the paying and collecting banker extends to bankers' drafts payable on

demand.[34] Bankers' drafts therefore give rise to no special problems in English law. Under Section 3-104(a) of the UCC, a negotiable instrument need not be drawn by one person on another, and, under Section 3-104(f), the definition of a check includes a "cashier's check." The issuer will be liable under Section 3-412 if it dishonors such an instrument.

Under Article 6 of the ULC, "[a] cheque may not be drawn on the drawer himself unless it is drawn by one establishment on another establishment belonging to the same drawer." This provision equates a banker's draft with a check so long as it is drawn on a department or branch other than that which draws it. A banker's draft will therefore be transferable and enforceable against the drawer in the same manner as any other check.

Forged and Stolen Checks: The Paying Banker

Forged Signature of the Drawer

The question, whether a drawee bank is entitled to debit its customer's (the drawer's) account where the purported signature of the drawer is a forgery, depends on the terms of the contract between the bank and its customer. In principle, in English law, the bank is not entitled to debit the account with the amount paid out, and British banks and building societies have so far refrained from departing by contract from this regime. If the customer has not authorized the payment, the bank cannot charge the customer with it. It is also well established in English law that the failure by the customer to keep his checkbook in safe custody or to take adequate steps in his business to prevent or detect fraud by his employees does not disentitle the customer from asserting that his account has been wrongly debited with the amounts paid out.[35] Nor is there any duty, in the absence of a contractual obligation to that effect, on the part of the customer to examine the bank statements periodically sent to him or her and to notify the bank of any discrepancy. Any stipulation by the bank in its standard conditions that, in the absence of such notification within a specified period of time, the account shall be deemed to be correct will be strictly construed and must be clear and unambiguous to achieve this result.[36] However, a failure by the customer to inform the bank that his or her signature on a check or checks is a forgery when this comes to the customer's knowledge will prevent the customer from asserting that his or her account has been wrongly debited if the bank has in consequence been prejudiced, for example, because the bank has lost the opportunity to recover the money from the forger due to his or her disappearance or because the bank has continued to pay money to the forger. Negligence on the part of the bank appears then to

be immaterial. The customer also owes a duty to the bank to refrain from drawing a check in such a manner as to facilitate fraud or forgery, that is to say, he or she must take reasonable and ordinary precautions when drawing a check to ensure that it is complete and not capable of being easily altered.[37] The current position in the United Kingdom, whereby the bank is in general liable regardless of whether the negligence of the customer contributed to the loss, has been criticized as unfair to banks, and the government proposes to consider whether contributory negligence on the part of the customer should be introduced as a defense so as to reduce the amount of the bank's debt or damages.

In contrast, a greater measure of protection is afforded to the bank by the UCC. Section 4-406 of the UCC expressly provides that the customer is under a duty to exercise reasonable care and promptness to examine his or her bank statements or items to discover an unauthorized payment and promptly to notify the bank if he or she discovers a discrepancy. If the bank proves that the customer has failed to do so, he or she is precluded from asserting against the bank any forgery or alteration, provided that the bank also proves that it has suffered loss by reason of the failure. A further consequence is that if, after a reasonable period for examination of the statement on which the first item appears (the period not to exceed 30 days), the bank pays in good faith any other item on which there is an unauthorized signature or alteration by the same wrongdoer and on which payment is made prior to the bank's receiving notification, the customer is precluded from asserting against the bank the unauthorized signature or alteration on that other item. Provision is made in Section 4-406(e) for apportionment of the loss where the bank has failed to exercise ordinary care in paying the item. Further, irrespective of whether the customer is careless or not, Section 4-406(f) takes away his or her right to object after one year from the time when the statement and items are made available to the customer. These provisions do not however affect the duty of the customer in any event to notify the bank of a known forgery. Nor do they affect the protection afforded to the bank by Section 3-406 where the customer has, by his or her negligence, substantially contributed to a material alteration of the check or to the making of a forged signature where the bank has paid the check in good faith.

Stolen Checks

A completed check may be stolen from the drawer, intercepted and stolen while in transit to the payee, or stolen from the payee. In each case, the thief is likely to forge any necessary endorsement of the payee on the check and then present the check or cause it to be presented to the drawee bank for payment, possibly by opening an account with the col-

lecting bank in the payee's name. In English law, in principle, the drawee banker's mandate is to pay only to a holder. The thief is not a holder, since the forged endorsement to him or her is wholly inoperative. Therefore, the drawee banker will not have paid in accordance with this mandate even though it makes the payment in good faith and without knowledge that the thief has no title to the instrument. Accordingly, the drawee banker is not entitled to debit its customer's account with the amount paid out. However, protection is afforded the drawee banker, under Section 60 of the BEA, if it pays in good faith and in the ordinary course of business a check payable to order drawn on it and, under Section 80, if the banker pays in good faith and without negligence a crossed check to a banker. Furthermore, Section 1 of the Cheques Act, 1957[38] virtually eliminated the need for an endorsement where the check is tendered for the credit of an account of the ostensible payee, because it provides that a banker who pays in good faith, in the ordinary course of business and in due course, a check that is drawn on it and that is not endorsed does not incur any liability by reason only of the absence of endorsement.

In the United States, a bank may charge against the account of a customer an item that is properly payable from the account,[39] but a check containing a forged endorsement is not properly payable. Section 3-201(b) of the UCC provides that negotiation of an instrument payable to order requires endorsement by the holder.[40] Again, however, Section 3-406 (regarding negligence that contributes to a forged signature or alteration of instrument) may assist the paying bank, as may also Section 3-404 (regarding impostors and fictitious payees) and Section 3-405 (regarding the employer's responsibility for fraudulent endorsement by an employee)

The ULC is significantly different. Under Article 35, "[t]he drawee who pays an endorsable cheque is bound to verify the regularity of the series of endorsements, but not the signature of the endorsers." This is consistent with the philosophy of the Geneva system, which allows title to a bill, note, or check to be acquired through or under a forged endorsement. Under Article 19 of the ULC, "[t]he possessor of an endorsable cheque is deemed to be the lawful holder if he or she establishes his title to the cheque through an uninterrupted series of endorsements, even if the last endorsement is in blank." In addition, under Article 21,

> [w]here a person has, in any manner whatsoever, been dispossessed of a cheque (whether it is a cheque to bearer or an endorsable cheque to which the holder establishes his right in the manner mentioned in Article 19), the holder into whose possession the cheque has come is not bound to give up the cheque unless he has acquired it in bad faith or unless in acquiring it he has been guilty of gross negligence.

Collection of Checks

Liability and Protection of the Collecting Bank

Most checks issued in the United Kingdom are not presented by the payee directly to the drawee bank for payment, but are remitted by the payee to his or her own bank, which arranges for their clearance. In such a case, the payee's bank may act as a collecting bank or as a discounting bank. When the bank presents the check to the drawee for payment on behalf of its customer, it acts as collecting bank and as the customer's agent. If the bank gives the customer value before the check is cleared—for example, if it grants the customer an overdraft against the check, or if it allows him or her to draw against it before clearance—then it acts as a discounting bank. The bank, in fact, presents the check in order to obtain payment for itself. However, the two roles are not necessarily exclusive. The bank may be, at one and the same time, an agent for collection and a discounter and holder of the check for value.

A bank may collect for a customer a check to which the customer has no title—for example, because it has been stolen. In that event, in English law, the bank will be liable to the true owner in tort (delict) for conversion of the check, because it is treated by the law as a tangible movable that is capable of being wrongfully appropriated. The measure of damages recoverable by the true owner from the bank is the face value of the check. Alternatively, the true owner could claim from the bank the sum collected on the check in restitution, because the bank has been unjustly enriched at the true owner's expense. However, this latter remedy would no longer be available once the bank had paid the proceeds of the check to its customer, the payee.

Protection against these claims is extended both to the collecting and discounting bank by Section 4 of the Cheques Act, 1957.[41] This section provides that a banker is not to be liable to the true owner of a check if he or she has received payment of it for a customer in good faith and without negligence despite any defects in the customer's title. There is quite considerable case law on this Section and on its predecessor, Section 82 of the BEA. Examples of negligence include placing to the credit of a customer's account checks drawn payable to his or her employer or to a company and failing to take up references when opening an account for the customer. However, the standard of care required is that of a reasonable man carrying on the business of a banker, and, in most instances, the banker will succeed in discharging the burden of proof placed upon him or her by showing that he or she has acted in accordance with prevailing banking practices. Under Section 4(3) of the Cheques Act, 1957, "[a] banker is not to be treated . . . as having been negligent by reason only

of his failure to concern himself with the absence of, or irregularity in, indorsement of an instrument." Even in those rare cases where the banker is found to have been negligent, damages may be reduced if the negligence of the true owner, for example, the payee, contributed to his or her own loss.

In addition, if the bank collects a check as discounting bank, it may in some circumstances be entitled to claim that it has become a holder in due course and, as a consequence, is to be regarded as the owner of the instrument. Again, under Section 2 of the Cheques Act, 1957, the bank need not show that the check (if payable to order) has been endorsed to it by the payee, since an unendorsed order check delivered to a bank for collection is deemed to have been endorsed in blank and so payable to bearer.

In the United States, Section 3-420 of the UCC provides that "[t]he law applicable to conversion of personal property applies to instruments." This Section also states that "[a]n instrument is converted if it is taken by transfer other than a negotiation, from a person not entitled to enforce the instrument or a bank obtains payment with respect to the instrument for a person entitled to enforce the instrument or receive payment."[42] This covers cases, for example, where a depositary bank takes a check bearing a forged endorsement. It will not acquire any greater rights by virtue of Section 4-205, which provides that a depositary bank becomes the holder of an item received for collection if the customer was at the time the holder of the item, whether or not the customer endorses it. Apart from the protection afforded to collecting banks other than the depositary bank by Section 3-420(c), there is no special protection given, as in English law, to bank collections. Moreover, the depositary bank that presents a check for payment to the drawee bank will be liable, on obtaining payment, on the presentment warranties imposed by Section 4-208. Again, however, the bank may be assisted by the previously noted Sections 3-404 to 3-406.

Delays

Sections 4-202, 4-214, 4-301, and 4-302 of the UCC impose time limits for the handling of certain items, and Section 4-109 deals with the possibility of a limited extension of these time limits by unilateral action on the part of the bank and in events of *force majeure*. In English law, a bank is allowed a "reasonable time" to present a check for payment. There are no statutory time limits. In practice, in the ordinary course the clearing of a check takes three days. The time taken to clear checks is often the subject of adverse (and perhaps unjustifiable) criticism by customers, in the press, and elsewhere. The Bank of England has now given

its approval for the introduction of a new system, the Real Time Gross Settlement System, which will greatly speed up interbank settlements.

Truncation of Checks

The present system used in the United Kingdom to clear checks requires the physical transfer of the paper to the branch of the drawee bank on which it is drawn. However, the BEA has now been amended[43] to permit the "truncation" of checks, that is, the transmission in electronic form of the details contained in the magnetic ink codeline on the bottom of the check rather than the check itself. A photocopy or some other reproduction in legible form, suitably marked and authenticated, is also accorded the status of evidence of the receipt by the payee of the sum payable by the check.[44] The truncation of checks will eliminate the transportation of millions of checks around the country each day. Some other European countries already have systems of truncation in place, and electronic presentment is permitted by Section 4-110 of the UCC.

COMMENT

JOHN R.H. KIMBALL

Check Truncation

The persistent success of checks as a principal means of noncash payment in countries such as the United States has resulted in efforts almost as persistent to make the collection of checks more efficient. Much efficiency can be achieved in terms of cost savings and speed of collection by the conversion of the paper check to electronic form at an early stage in the collection process, particularly where the banking system is fragmented, and multiple sorts of checks are now necessary. The magnetic ink characters on the bottom of the check are transmitted to the payer's bank in place of the original check. This process is often called "truncation," and is distinguished from the mere safekeeping of paid paper checks at the payer's bank.

The principal difficulty with implementing a check truncation system, at least from the point of view of a lawyer, is the increased risk to the payer's bank of paying a forged check, defined as a check with an unauthorized or missing payer's signature. Under most countries' laws, the payer's bank is responsible for authenticating the payer's signature. Existing truncation systems deal with the risk of the payer's bank in various ways. Most common is a limit on the value of checks that may be truncated; such limits exist in truncation systems in Germany,[1] Spain,[2] and the United States.[3] Because the payer's bank often does not examine small-value checks today, but assumes the risk of a forgery, truncation would not increase the risk of the payer's bank, if such limits are set at an appropriate level.

The payer's bank also has other means of protecting itself in a truncation system. For example, the payer's bank may require the payer to notify it when the payer draws a check above a certain amount, so that the payer's bank can reconcile the notice with the truncated check when received (sometimes called a "positive pay" system). This system, of course, detracts from the attractiveness of checks to consumer payers. Another means of reducing the risk of the payer's bank is for the truncating bank to transmit a digital image of the check itself to the payer's bank in addition to the magnetic ink information, particularly for larger-value checks. While an image may enable the payer's bank to feel secure in paying a check in many cases, some payer's banks say that signature

verification or other examination of an image is not a particularly reliable means of authentication and that it is more reliable in authenticating a check to examine the quality of the paper, the nature of the printing, and other details on an original check.

Perhaps the most effective way of protecting the payer's bank from the risk of forged checks is to shift that risk back down the collection chain to the bank of first deposit and its customer, the payee of the check. This shifting of risk is the effect of systems that use a check guarantee card, such as the Eurocheque system. In such a system, the payer's bank guarantees to pay a check if the payee compares certain information on the check with information on the card exhibited by the payer. The payee and its bank then may guarantee to the payer's bank that these procedures have been complied with, and the payer's bank may later recover from the payee's bank and the payee if it turns out that the check was forged. As an example of the benefits of such a system, Eurocheques (generally of small value) are truncated and collected by electronic transmission throughout Europe.

Recently, some regional check clearinghouses in the United States have adopted rules that permit the payer's bank to return a check to another member of the clearinghouse within a stated time, such as 60 days, with an affidavit by the payer that its signature was not authorized. In some cases, these rules are limited to checks that bear only a statement by a third party that the payer has authorized it to issue the check. This type of check is used when a sales firm attempts to obtain an authorization from the payer over the telephone in connection with an attempted sale, and is increasingly common in the United States. These clearinghouse rules shift the authentication responsibility of the payer's bank to the payee's bank and the payee, but without giving the payee a ready means, such as a check guarantee card, to protect itself. Such rules also delay the time of final payment of a check, thereby increasing the risk of the payee's bank in giving prompt availability of funds to the payee for checks deposited. It will be interesting to see if these rules are found to be acceptable to payees and payers, and whether, as a result, payees begin to refuse to accept checks in cases where they cannot readily be authenticated, such as through the mail.

A truncation system must also provide rules for the storage of original checks and copies thereof by the truncating bank, for the return of unpaid checks, and for the retrieval of copies of checks on request by the payer. Payers may need a copy of a check, in addition to a bank statement, in order to prove payment in a particular case or to comply with a variety of laws that require certain categories of payers to keep paid checks for audit purposes. Responsibility for the accuracy of the transmitted mag-

netic ink information must be determined. A truncation system also must allocate responsibility for complying with postdated and stale-dated checks, and with any legends on a check, such as "not valid for more than ___," because the magnetic ink information does not include information from a check other than the amount and check number, if any. In certain countries, a truncation system must also allocate responsibility for determining the regularity of endorsements.

Given the number and difficulty of these legal issues, not to speak of issues relating to technology and pricing, it is not surprising that truncation has not yet become more widespread. Yet the challenge remains to reduce the costs and increase the speed and security of check collection. The following hypotheticals raise issues concerning check collection and truncation.

Hypotheticals

Hypothetical Number 1: Collecting Bank Liability

The following hypothetical raises problems that could arise during the collection of a check.

Your bank (Your Bank) acts as an intermediary collecting bank in handling checks for collection. You receive a letter from a lawyer for the bank of first deposit (Bank 1) demanding credit and other damages for a check in the amount of $27,500 received by Your Bank from Bank 1 and later charged back to it by Your Bank. The letter recites the following facts:

- January 5: check deposited in Bank 1 by payee; check sent to Your Bank by Bank 1; credit given to Bank 1;
- January 29: photocopy requested from Bank 1 by Your Bank because original was reported lost by paying bank (Bank 3);
- February 16: photocopy supplied by Bank 1;
- March 4: photocopy returned and credit charged back to Bank 1 by Your Bank; only $10 left in payee's account;
- March 13: Bank 1 sends form to Your Bank claiming late return by Bank 3; credit given to Bank 1;
- April 15: Bank 3's denial of late return charged back to Bank 1 by Your Bank.

Information from Bank 3 states:

- February 21: photocopy received by Bank 3;
- February 29: photocopy returned by Bank 3; notice of nonpayment not given by telephone or wire.

The lawyer for Bank 1 alleges:

- negligence by Your Bank in not giving prompt notice of nonpayment or loss after January 5;
- breach of warranty of timely return by Bank 3;
- negligence of Your Bank in losing check;
- negligence by Your Bank in not reversing credit for late return claim promptly after March 13; and
- unfair and deceptive acts and practices (treble damages).

After you ask for help from your Operations Department, it researches the matter, expresses supreme satisfaction with its handling of the check, confirms the above dates, and adds:

- January 8: Your Bank sends check to Bank 3;
- January 22: Bank 3 requests credit for January 8 cash letter (bundle of checks) not received.

How do you respond?

Hypothetical Number 2: Truncation

The following hypothetical raises issues concerning the introduction of a check truncation system:

A city check clearinghouse wishes to promote check truncation to save its members processing costs. The clearinghouse has as members most of the banks in the city, both large and small. The Truncation Committee of the clearinghouse proposes a rule that would require all member banks to present checks to other members by electronic transmission of magnetic ink information on the bottom of the check by the 10 a.m. clearing time. The paying bank would be required to pay based on this information. The rule would require the presenting bank to store the original check for 90 days and a copy for 6 years, and to supply the original or a copy to the paying bank on request at a set fee.

The proposed rule is controversial. The smaller banks complain that they are not operationally ready to process checks based solely on the magnetic ink information or to store checks, and that their customers will demand the original check in many cases because they fear not being able to prove payment without the original. The smaller banks request that the originals be delivered to the paying bank later on the day after transmission so that the checks can be supplied with the statement to their customers.

The larger banks support the proposal for small-value checks (the vast majority of checks by number), but object to the proposal for large-value

checks because they are unable to verify the authenticity of a check from the magnetic ink information. If a forged check is paid, the paying bank will be required to recredit the customer's account, and may not be able to recover its mistaken payment from the forger. The larger banks demand that the presenting bank be required to guarantee the validity of the check writer's signature on checks over a certain amount. They argue that the presenting bank or its customer (the payee) is in the best position to determine whether a check is valid when it accepts the check in payment.

The Truncation Committee of the clearinghouse (dominated by technicians from the larger banks) insists that the savings in processing costs from truncation will outweigh some increased risk of paying forged checks and will convince customers to accept a statement showing only check number, amount, and date of payment. It argues that the savings from truncation will be much greater when city clearinghouses begin exchanging magnetic ink information between each other in place of original checks. However, in deference to the lawyers from the smaller banks, the Committee agrees to modify the proposal to be implemented in phases. Phase 1 would begin with the truncation of smaller-value checks (60 percent by total number of checks in the clearing), and one of the larger banks would provide the service for other banks of storing checks and supplying copies on request. Phase 2 would require the presenting bank to guarantee the validity of checks over a certain amount and would provide for truncation of all checks.

When news of the proposed rules leaks out, a coalition of consumer groups protests the changes as contrary to the check statute and the check writer's ownership of a paid check. In addition, a coalition of retailers protests that presenting and paying banks will attempt to return forged checks to payees long after they have been finally paid, contrary to the check statute.

What do you advise the central bank that regulates the banks and the check system?

COMMENT

BARKLEY CLARK

Key Issues in U.S. Check Collection Law

In the United States, approximately 60 billion checks were written in 1995. This amount was an all-time high for a number that has been increasing every year. Consequently, any report on the demise of the check as a form of payment is certainly premature. The checking system will certainly remain an important component of the payment system in the United States and in a number of other countries as well. Wholesale wire transfers are relatively small in number but huge in amount. Electronic cash, or e-cash, payments are likely to be numerous but small in amount. However, checks run the gamut. They can be large corporate checks or small consumer checks.

Checks have many advantages for consumers. During the recent redrafting of the Uniform Commercial Code (UCC), consumer groups reflected their strong concerns about maintaining the check system. The right to stop payment is sacred to the drawer of a check. In this sense, drawers of checks play the float every day when they write checks with the expectation that they will be depositing the funds to cover the check by the time the check is finally presented two or three days later. As part of their cash management, corporations frequently play the float with checks and other paper-based instruments, such as various types of drafts. People who draw checks are aware that if a drawee bank wrongfully dishonors their check, they can go after that bank for whatever damages they sustain. Moreover, customers like to draw checks because they can use them as receipts for their bills.

Consequently, the check system, as a legal payments system, will continue to be popular. The aggregate number of checks in the United States may peak at 75 billion and then decline over time, but this is not likely to happen overnight or even within the next 20 or 25 years. Despite the fact that some major payors by check, such as the U.S. government, have recently decided basically to do away with the paper check system of payment and go with other systems, checks are still going to be extremely important.

Hypotheticals

The following hypotheticals deal with three specific and heavily litigated problems of check fraud in the United States. A constant theme is how

to allocate the risk in check collection. The hypotheticals address (i) preauthorized drafts or telechecks (basically forged checks), (ii) forged endorsements, and (iii) a different form of check fraud that takes advantage of the float called "check kiting." From these hypotheticals, one may begin to glean where the problems are and maybe some of the pitfalls to avoid when drafting a new system or working with an emerging system of check collection.

Hypothetical Number 1: Preauthorized Drafts (Telechecks)

Hypothetical Number 1 deals with the so-called preauthorized draft known as a "telecheck" or "teledraft." The following typical situation is becoming increasingly prevalent in the United States.

A telemarketing company contacts a prospective buyer of encyclopedias over the phone. The telemarketer says, "We have got some encyclopedias for you. They are $750. Would you like to buy them?" The customer thinks about this offer and says, "Yes, I think I would like to buy them." The telemarketer then asks that payment be made by check rather than credit card. Historically, credit card information has been given over the phone to pay for such purchases. However, telemarketers would prefer to have the payment by check because they would like to get quicker payment, and they do not want to run the credit risk. The customer might then say, "Well, I would like to send you the check." Rather than wait for the customer to send his check for the encyclopedias, the telemarketer offers to handle the check transaction. The telemarketer asks the customer to grab a blank check and read over the phone the relevant MICR[1] line information—particularly the routing number of the drawee bank and the customer's account number. The telemarketer takes the MICR line information and uses desktop publishing technology to produce a check for $750 with the customer's MICR line information encoded on the bottom, just as though it were the customer's own check. On the bottom right-hand corner of the check, where the customer's signature would normally appear, the telemarketer stamps "Debiting of account authorized by customer" or simply "Authorized by customer." The customer never signs the check. The telemarketer then deposits the check in its bank (the payee's bank), and the check is handled from then on as a standard cash item. Based on its general policy, the drawee bank does not verify the signature on the check before payment. Only the MICR line information, which contains the amount of the check, is read. Approximately 40 percent of the time, the check will end up going through one of the federal reserve banks. Ultimately, the check is paid by the drawee bank and the customer's account is debited. However, when the customer gets his statement at the end of the month, he lets out a piercing scream. He now feels that

he was defrauded by the telemarketer. He insists that the drawee bank re-credit his account. What are the rights and duties of the drawee bank?

Few U.S. banks verify signatures on smaller-value checks, such as that in the hypothetical, except perhaps on a random basis. Most banks have a threshold of $5,000, $10,000, or $15,000 above which they verify the signature of the drawer. Therefore, the check in the hypothetical is going to get paid. Nobody is going to notice that the drawer never signed the check. The account gets debited $750. In many cases, that is the end of the story. The encyclopedias are delivered without any problem, and the transaction is closed. However, in some cases, the customer feels defrauded in some way—that he or she was overcharged for the encyclopedias, that the product was not really what had been ordered, or that he or she had rejected the encyclopedias altogether. Yet, there is a check debiting the customer's account. Consequently, what is the buyer to do? He or she will probably call up his or her bank immediately or perhaps at the end of the month when the canceled checks are received. The buyer will see the check that was never signed, but which was produced by the telemarketer.

What is the bank to do when their customer insists that his or her account be re-credited? As noted in previous chapters, when a drawer's signature is forged or not authorized, the check—as a legal matter—is not properly payable. Consequently, the account cannot be debited. Therefore, the customer will say that the signature was unauthorized. He or she will say, "I never signed the check. I never authorized that purchase of encyclopedias. Therefore, I demand that my account be re-credited." If the bank agrees with its customer and re-credits the account for $750, the bank will not be able to kick that check back upstream to the bank of first deposit or to the telemarketer generally because the rule in the United States and in a number of other countries is finality. The rule of finality stems from an eighteenth century decision by Lord Mansfield, who said that once an item is paid that is the end—payment cannot be reversed in that type of forged drawer's signature situation. Therefore, the bank cannot kick the check back. If, on the other hand, the customer stops payment on the check before it clears, the bank can kick the check back upstream. However, in most of these cases the customer does not move that quickly. The result is that the drawee bank—the payor bank—is going to be left with the loss.

In such a case, should the bank voluntarily comply with the customer's request to re-credit the account? No, unless the bank is prepared to assume the loss. How can the loss be shifted to the customer? On the theory that the customer was the one who set this instrument adrift by being willing to give his or her MICR-line information over the phone? Several legal approaches can be taken. One approach is that the

customer's signature was authorized. The customer told the telemarketer over the phone that he or she wanted to buy $750 worth of encyclopedias and then authorized the telemarketers to send the check through the system. In many cases, there is a tape recording of the phone conversation. Therefore, the authority for signing the check will be established, the check is properly payable, and the bank should not be re-crediting its customer's account.

On the other hand, the customer may say, "No, the check was not authorized." The customer's argument is primarily directed against the telemarketer's contention. Is there anything that the bank can do in a situation like this? One suggestion—which is risk shifting—is through private contract. The bank could put in the terms and conditions of deposit agreements with customers a special clause that says, "If the customer writes or gives information about his or her check over the phone to some third party, the check is deemed to be an authorized check." Banks could try to impose more risk on the customer through private agreement. In some cases, this risk shifting will work, although the courts have not really tested this yet. However, under the UCC, it seems that this kind of freedom of contract is probably justified.

Another approach for the bank to take, at least in the U.S. system, is to argue that the customer was negligent by giving out information in this way and facilitating this kind of check. The problem with this approach is that the customer then can point to the bank and argue the bank was also negligent and, therefore, that the bank and the customer should split the risk on a comparative fault basis, which is recognized in the U.S. system. On this point, there is an interesting question that is arising in an increasing number of cases. Is the bank negligent if it simply does not check signatures below a certain threshold? The UCC has a provision that says in effect that if the bank does not verify signatures and if the bank is doing what other banks in the trade area do (that is, it is the industry practice not to verify signatures below a certain threshold), then the bank is deemed to be not negligent.[2] On that theory, the entire loss could be left on the customer.

In cases of dispute, there will be some jockeying back and forth between the bank as the drawee and the customer as the drawer of this check. However, if the bank decides to re-credit the customer's account and if it does not want to raise the defense that the check is unauthorized or that the customer was negligent, the bank will have to sustain the loss, unless it is in the kind of truncation system referred to in the prior chapter. If the bank is in a truncation system—where all the banks have joined together in a single clearinghouse—and all the banks have agreed that in a forged check situation the loss can be kicked back upstream to the prior

banks—the bank may be spared the loss. However, absent that rather specialized case, the loss is going to be left either with the drawer or the drawee bank. If the loss is left with the drawer, the drawer can always sue the telemarketer for fraud. However, at least the bank has removed risk of loss on its account.

Additional problems may be related to the preauthorized draft. Is a preauthorized draft covered by Regulation E of the Federal Reserve Board, which gives consumer protection in certain situations?[3] Probably it is not protected. If a preauthorized draft were subject to Regulation E, the customer would generally be protected from that kind of unauthorized signature.[4] In some situations, there is an interplay between regulatory law and the basic rules of check collection under the UCC. However, Regulation E does not seem to cover this type of paper-based system.

Perhaps a better rule is not to have the loss lie with the drawee bank on the theory that the drawee bank's employees check every single signature because such practice is outmoded and no U.S. bank continues to do this. That outmoded practice is the rationale of the original rule. Perhaps the rule should be changed and a new rule should allow the check to be kicked back in all cases to the bank of first deposit or to the payee. Countries thinking about developing a check collection system and fraud rules should consider these possibilities and whether customer negligence should be relevant, as it is under the U.S. system.

Ultimately, the key legal question in such cases is whether the signature is authorized. The UCC has a broad definition of signature. A person does not actually have to write his or her signature on a check. Somebody else can do it as his or her agent. The agent can bind the principal in such situation. Because of the risk of check fraud and because of the explosion of desktop publishing, recent statistics have indicated that in the United States there is a new high level of fraud loss. Estimates are as high as $7–$10 billion a year due to check fraud. There are several reasons for this increase. One reason is the quicker release of check holds. However, another perhaps more fundamental reason is that there are more fraudsters counterfeiting and forging checks because of the technological innovations of desktop publishing.

One of the newest approaches for corporations to avoid the risk of loss is to enter into what is known as a "positive pay agreement." This may also enable the drawee bank to avoid the risk and to shift the risk back. Under a positive pay agreement, every day the corporate customer sends by modem a list of the checks that it has issued. The bank then compares that list with its own presentment data and reconciles it. If some checks are presented that are not on the issuance list, a red flag is raised. Those

checks are probably forged. They are sent back to the drawer to make a decision. Under the U.S. system, the decision has to be made by the midnight deadline—the midnight of the day after the day on which the check was presented. The bank has to either pay it or dishonor it. Therefore, under a positive pay system, the process may be done electronically so that a decision can be made. The customer will call the bank and say, "Pay the check, even though it did not reconcile," or say, "Please dishonor that check." Currently, there is a proliferation of positive pay products for corporate customers. They are an attempt to shift the risk of drawer's signature fraud.

Suppose there is a positive pay system, the risk is shifted, and before the midnight deadline the check is sent back. Who bears the loss? It will go back through the chain, and the loss will finally be left with the bank of first deposit, which in turn can charge the item back against the payee. A dramatic difference results from whether there is a positive pay system in place in order to shift the loss back upstream from either the drawer or the drawee bank to the bank of first deposit, which then may be able to charge the item back against the depositor.

Hypothetical Number 2: Forged Endorsements

In the United Kingdom and the United States, there is increasing litigation regarding forged endorsements. Clever embezzlers are at work everywhere. Many of these people are employees of either the drawer of the check or the payee of the check or, as in this hypothetical, simply outright thieves.

Drawer draws a $5,000 check to the order of Payee. The check is stolen from Payee by Thief, who signs Payee's name to the check as a blank endorsement. Thief then delivers the check to Faith, who purchases the item for value in good faith and without noticing that the endorsement was forged. Faith deposits the check with Depositary Bank, which presents the check through the Federal Reserve and receives payment from Payor Bank. In the meantime, Depositary Bank gave Faith provisional credit for the item, and Faith withdrew that credit. Payee then notifies Drawer of the theft. Drawer notifies Payor Bank but is told that the check has already been paid.

Is Payee entitled to repayment by Drawer? If not, could Payee sue Payor Bank or Depositary Bank on a conversion theory? If Drawer voluntarily pays Payee a second time, can Drawer require Payor Bank to recredit its account? If so, can Payor Bank kick the loss upstream to Depositary Bank or Faith? Can the victorious party in the litigation collect its attorney's fees from the loser?

The first question to be addressed is whether the payee is entitled to a second payment from the drawer. The drawer of the $5,000 check had his or her account debited, so he or she does not want to pay a second time. On the other hand, the intended payee never got paid, so he or she wants to get paid. Under the UCC, the payee has a right to get paid. If the check was not delivered, the underlying debt remains. If the check was delivered, there still could be an action on the check, treating it as a lost check against the drawer. So either way, the intended payee can sue the drawer. Then what happens?

The drawer, of course, will then try to shift the loss to its bank. In such a case, the U.S. system is quite different from the other systems mentioned in Chapter 7. Under the U.S. system, if the check has been paid on a forged endorsement, it is (i) like a forged check, (ii) treated as not properly payable, and (iii) unauthorized; nobody can be a holder in due course of that check. As a result, the drawer, who has to pay a second time, can get $5,000 re-credited to his or her account. The loss is shifted to the drawee bank. What can the drawee bank do then?

Under the U.S. system of warranties, every bank that passes a check along warrants that there is no forged endorsement. Therefore, the loss goes from the intended payee, to the drawer, to the drawer's bank, and then back upstream until the loss is left with the bank of first deposit. The bank of first deposit, if it can, would then have a right to charge the loss back against the good faith third party. Consequently, the person who took it from the forger ends up with the loss. The rationale for this rule is that the loss should be left with the party who took it from the defrauder.

However, there are other options open to the intended payee under the UCC. For example, the intended payee could sue the drawee bank (the payor bank) immediately for conversion and then go back upstream. In most cases, the intended payee sues the bank of first deposit for conversion of the check. The check was not properly payable. Therefore, the bank of first deposit should have to suffer the loss. That kind of a direct lawsuit is frequently brought so as to avoid having to sue a number of different drawee banks because many of these fraudsters do not do forge endorsements one at a time. Instead, they do it hundreds of times. Some dishonest bookkeepers are able to commit this type of check fraud thousands of times over three or four years before they finally get caught by an auditor. The end result is that, in most of these cases, it is the bank of first deposit or the customer who took it from the fraudster who will suffer the loss.

Other questions arise. For example, can U.S. banks cover this risk by insurance? Some U.S. banks obtain check fraud–loss insurance under the

standard banker's blanket bond. It is one way of shifting the loss to the insurance company. Can an attorney's fees be collected by the winning party? No, the rule is that whoever has to litigate this under the U.S. system and ends up winning cannot collect the attorney's fees. In this hypothetical, the litigation could shift the $5,000 loss back but could not collect associated attorneys' fees. These fees may exceed the face amount of the check.

One final point regarding this hypothetical is that special rules apply under the UCC if the fraudster is or was an employee of either the drawer or the intended payee.[5] The theory is that where the crime was committed by an insider—an employee—the loss should be borne by the company that hired, but did not adequately monitor, this person and that did not check the employee's reconciliation of checks at the end of the month. Under the UCC, in this type of forged endorsement situation a substantial amount or perhaps all of the loss can be shifted to the employer who hired the dishonest employee.[6]

Hypothetical Number 3: Check Kiting and the Midnight Deadline

One of the problems with a paper-based check system that does not arise in other types of systems, or at least it is not as serious, is the 2–10 days that it may take for a check to be paid as it goes through the system from a bank of first deposit to the drawee or payor bank. This period of time is called the float. It is simultaneously one of the advantages and disadvantages of the check collection system. Some fraudsters play the float as a vehicle for check fraud. The following hypothetical is an example of this type of fraud, called "check kiting."

For three years, Clarence Crook engaged in a check-kiting scheme. Crook created artificial balances in accounts at First National Bank and Second National Bank by taking advantage of both banks' willingness to pay his checks even though they were drawn on uncollected funds. He first deposited checks in First National Bank drawn on Second National Bank. First National Bank, believing that the deposit was real, permitted Crook to draw a check, which he then deposited in Second National Bank. The checks went back and forth, and as a consequence, Crook built up an artificial balance between the two banks. Crook was able to divert over $3.5 million from the accounts into payment of his gambling debts. Finally, it dawns on Second National Bank that a kite might be taking place. Without any warning to First National Bank, Second National Bank brings the kite down by suddenly dishonoring checks drawn on it that are based on uncollected deposits of checks drawn on First National Bank. First National Bank allows its midnight deadline to expire on $3.5 million in checks on the assumption that they will be paid by Second

National Bank as they have in the past. When First National Bank receives these checks as insufficient funds return items, it seeks to return them under the Federal Reserve's "challenge" procedure. When this approach fails, First National Bank sues Second National Bank on several theories: (i) allocation of the kiting loss based on comparative fault principles, (ii) return of the $3.5 million in checks based on payment by "mistake," and (iii) bad faith on the part of Second National Bank for failing to warn First National Bank once it discovered the kite. Who bears the loss?

In the United States, there has been a significant amount of litigation regarding check kiting. One of the two banks is normally going to bear the risk. Normally, it will be the bank that discovers the kite last. Kites succeed for two reasons. First, banks are willing to pay checks on uncollected funds. They are willing to pay checks and let customers draw money out of their accounts even though the checks are not collected because of the float in the system.

Another important factor in check kiting is the midnight deadline. In a typical kite, one of the banks will realize one day that it is in the middle of a check kite. Sometimes banks have kite detection software that will alert them. Sometimes a Federal Bureau of Investigation telephone call alerts the bank. One of the banks may discover the kite before the other one does. What should that bank do? Ordinarily, it will return all checks that are coming through and are going to be presented on that bank for insufficient or uncollected funds. The other bank, which still is not aware that a kite is going on, will pay the checks drawn on it. Then, 100 percent of the loss is left with the bank that discovered the kite last because it was not able to kick its checks back before the midnight deadline. That is the rule under the U.S. system. The bank bears the overdraft risk if it does not return the checks before the midnight deadline.

Is there any way that a bank can shift that loss away from itself if it was slow in returning checks? Banks have tried very hard to do this. When several million dollars are involved in a big kite, which is frequently the case, banks will work very hard to shift the risk away from themselves. Some banks try to do it on a comparative fault basis—both banks should have known of the kite earlier, but they did not discover it so they agree to split equally the loss. The U.S. courts have uniformly rejected that approach. The courts have held that there is no comparative fault system applicable to this situation. There is for forged checks, but not for check-kiting risk. If a bank lets the midnight deadline go by, it bears 100 percent of the risk.

The argument has also been made that the bank that bounced the checks had a duty to notify the other bank of the kite instead of craftily sending back its checks for insufficient funds. The courts have rejected

that approach also. They have said that it is not bad faith for a bank that discovers a kite first to protect itself by quietly returning checks drawn on it and moving checks along that are deposited with it. Consequently, almost every attempt by the slower bank to shift the loss onto the bank that first discovers the fraud will not be successful under U.S. law. However, there is no doubt that this is one of the key problems in check fraud.

Magnetic Ink Fraud

A fourth form of check fraud is on the increase. It could be called "MICR fraud," or "magnetic ink fraud." Every check has at the bottom a magnetic line that gives the number of the bank on which the check is drawn and the customer's account number. Once the check goes to the bank of first deposit, the magnetic line will contain the amount of the check. Then, the check can be routed forward, and, in a truncation system, it would be allowed to be truncated at the bank of first deposit. Ingenious fraudsters with the aid of desktop publishing technology take the MICR line, which identifies Bank A as the payor bank, and on the face of the check they will indicate Bank B as the payor bank. In addition, in the upper right-hand corner of most checks there is a special Federal Reserve fraction, which gives the special Federal Reserve number of that bank and the district in which it is located. With desktop publishing, the fraudster can put those designations at variance with one another. The fraudster may take a check like this and deposit it for collection into his account. The bank normally would put a hold on the check and not allow him to draw the money out immediately. However, the fraudster may be confident that he can create so much confusion through the three different bank designations that this check will bounce around in the system for maybe 15 or 20 days.

Various banks can get confused by this kind of MICR fraud. The theory is that the check will first go to the payor bank, whose number is indicated. This bank will return it with a note that the drawer does not have an account at such bank. Then, the check may go to the Federal Reserve Bank. The Federal Reserve Bank will examine it and may send it to the named payor bank, which will also send it back and note that the drawer has no account there. By the time the check gets back to the bank of first deposit, the fraudster usually has taken out of his bank account the money that the bank of deposit granted him provisionally.

This type of fraud is going to continue to grow. However, Regulation CC promulgated by the Federal Reserve Board does affect MICR fraud by requiring that if a check is sent to a bank, even though the customer

does not have an account at that bank, such bank will be treated as the payor bank and has a duty (if the check exceeds $2,500 in amount) to notify the bank of first deposit within a couple of days that it is returning the check.[7] Thus, Regulation CC will alleviate some of these problems, but MICR fraud will likely continue in other ways.

Conclusion

The primary question in many respects is, How can banks change the statutory allocation of loss? To what extent can this allocation of risk be changed by clearinghouse rules, by private agreement, or by some other approach? Check fraud exists in every check collection system in the world. It is a serious problem that is going to continue, and bankers must be prepared to deal with its consequences.

Afterword to Chapters 6 and 7

OLIVER IRELAND

The two preceding chapters focused on matters concerning payment systems. It is clear from them that payment system processes and issues are detailed and complex. In order to provide certainty as to how the issues that arise in these systems will be resolved, the law applicable to a system may also need to be detailed and complex. For low-value payments, the need for this certainty may be relatively low, and the development of a complex legal framework to support the arrangement may not be justified. However, as payment values grow, either in terms of the size of individual payments or in terms of the aggregate size of the payments, the case for a detailed legal framework for the payments becomes stronger.

As the need for the law crystallizes, it becomes necessary to consider how that framework might be supplied. Two broad sources are apparent—public law and private law. In this context, public law means governmental statutes or regulations, and private law means private agreements, whether in the form of individual agreements between the parties, clearinghouse rules, or the like.

Public law has the advantages of certainty, stability, and convenience. Statutes and regulations can be developed, and their character may afford a relatively high degree of assurance that they will be enforced by the courts. Furthermore, statutes and regulations can be applied to all interested parties in a transaction, even though they may not have entered into agreements covering all aspects of the transaction. Thus, the conduct of business under public law may be simpler than under private law because the step of obtaining agreements from all interested parties can be bypassed. On the other hand, public law can be relatively inflexible—preventing or discouraging innovation or experimentation that does not fit its precise standards.

Private law offers the advantage of greater flexibility than public law. This flexibility facilitates innovation and experimentation in the development of payment systems because individual systems can tailor their legal rules to their needs by means of agreements. However, the private law approach has disadvantages because agreements may have to be obtained between the parties, and initially, judicial willingness to enforce at least some portion of the agreements may be in doubt.

Generally, the use of public law for defining the rights of participants in payment systems is most appropriate where the procedures and practices with respect to that payment system are well established. In these

circumstances, the public law serves to codify existing practices, thereby obviating the need for specific agreements. In these circumstances, public law can also serve to correct problems that have developed, which the private markets have been unable to rectify. The check collection system in the United States and the application of the Uniform Commercial Code to that system is a good example of the codification of the rules of an established system, although the area of truncation has many of the characteristics of an emerging system. Various consumer protection statutes in the United States, such as the Truth in Lending Act[1] and Truth in Savings Act,[2] are examples of a felt need to rectify problems in established markets through public law.

For newer payment systems, reliance on private law may be more appropriate. In these circumstances, procedures and practices may be fluid rather than well established. In addition, the volume of payments that will ultimately be involved in new systems is usually unclear. Reliance on private law will allow the maximum possible innovation and experimentation in developing procedures and risk allocations that are best suited to new systems. Reliance on private law will entail costs to the developers of the system in terms of the need to obtain appropriate agreements. Indeed, the desire to avoid these costs may cause system developers to advocate the adoption of public law. However, reliance on private law has the advantage of avoiding the public costs of developing laws that may have limited applicability if the system does not attain wide acceptance. The current status of e-cash in the United States is a good example of an emerging payment system that might well be handled most effectively through private law.

Finally, central banks must always be cognizant of an additional factor in formulating their views as to whether public law or private law is most appropriate in particular circumstances. This factor is consideration of systemic risk. Where it is apparent that a payment system is, or will rapidly become, so large that a disruption in its activities may have unacceptable systemic consequences to the payment system and even beyond it, central bankers will want to be confident that legal problems will not be a significant factor in contributing to those consequences. In certain cases, the greater certainty of public law, as well as other public policy considerations potentially including the appropriate allocation of risk, will weigh in favor of public law for systems that otherwise may present unacceptable levels of systemic risk.

In sum, careful consideration should be given to how a legal framework for payment systems is established. Central bankers should resist the temptation to codify arrangements too early. While codification may reduce visible problems such as litigation, it often has less visible effects and costs, such as discouraging or limiting desirable innovation and development.

Foreword to Chapters 8 and 9

MANUEL GUITIÁN

Dealing with Banks in Distress: Key Issues

In recent years, a broad and diverse range of countries—industrial, developing, and formerly centrally planned—have experienced significant banking difficulties. A recent survey undertaken by the Monetary and Exchange Affairs Department of the International Monetary Fund indicated that problems of this nature had arisen in nearly three-fourths of the total IMF membership (131 out of the Fund's 182 member countries). These incidents have occurred even in economies such as those of the United States, Japan, and the Nordic countries, and, as a consequence, there has also been a growing recognition of the significance of banking system soundness for macroeconomic stability, an area in which central banks carry a major responsibility. Accordingly, increasing attention is being devoted to means of improving existing frameworks for preventing the recurrence of new banking sector difficulties as well as to the design of strategies for resolving individual and systemic bank problems when they do occur. In the IMF, the Monetary and Exchange Affairs and the Legal Departments have been heavily involved in these issues. Among other activities, the IMF has been called upon to coordinate the technical assistance of OECD countries' central banks in this area.

Chapters 8 and 9 identify some of the most important issues that have arisen with respect to both the prevention and the resolution of banking system problems and how those frameworks can best be updated and extended to address the issues. Case histories of bank failures in the United States, the Nordic countries, and Latin America are presented and examined.

Prevention of Banking Problems

The key to preventing banking difficulties lies in the existence of proper arrangements to facilitate efficient banking and to ensure that banking activities are conducted in a sound manner. Those arrangements have several key components.

Institutional Setting

Banks must be able to operate within a comprehensive, internally consistent, and transparent legal and regulatory framework that sets out well-

defined rules on how they must conduct their activities in a prudent and efficient manner. This framework must also provide banks with the instruments for their operation (for example, basic laws on contract, collateral, property, and bankruptcy) and an effective judicial system for enforcing contracts with their customers.

Internal Discipline

In order to avoid problems, banks must have good internal governance. Consequently, rules must be established on both the qualifications of owners, directors, and managers of banks, and the requirements these individuals should fulfill on an ongoing basis for operating a bank in a sound and proper fashion. These rules should apply whether banks are state owned or privately owned.

External Discipline

Private Surveillance

Market forces also are significant factors in promoting bank soundness by enforcing discipline on bank owners and managers. Effective discipline requires competition and informed bank customers. The laws and regulations underlying banking activity must ensure that these conditions are met. This is important because market discipline can serve as a powerful complement to official oversight.

Official Surveillance

Banking supervision has a key role in ensuring that banks conduct their activities in a sound manner. However, to be effective, bank supervisors must have sufficient authority and independence to establish and enforce prudential regulations, to obtain the information necessary in order to evaluate the effectiveness of governance and the financial conditions of banks, and to take corrective action against banks that are not operating in accordance with proper banking practices. Such powers must also be flexible enough to allow supervisors to adapt their criteria and instruments for monitoring diverse currently recognized risks (including market and transaction risks as well as credit risks) and new risks as they may evolve over time (for example, the new risks associated with derivatives). Supervisors must also have the power to enforce the exit of insolvent institutions.

Resolution of Banking Problems

The design of the legal and institutional infrastructures needed to underpin banking activity should give priority to the prevention of bank-

ing difficulties. However, methods also have to be provided to deal effectively and quickly with banking problems when they emerge so as to limit their effect on the proper functioning of the banking system and of the economy at large. Within the variety of those methods, it is important to distinguish between instruments for dealing with individual bank vulnerability and those for dealing with problems that may affect the entire banking system (that is, systemic problems).

In dealing with individual problem banks, supervisors must have sufficient power to enforce corrective actions to restore a bank to financial soundness. Should the scope for such actions already be exhausted, supervisors must be given the authority to force the exit of the bank in a timely fashion in order to avoid growing distortions, bad practices, and moral hazard with potentially adverse spillover effects. The relative roles of the supervisory authorities and the courts in these processes must be carefully defined in order to ensure timeliness and efficiency.

Because systemic banking problems have major macroeconomic implications, they cannot be dealt with on a case-by-case basis or through mass liquidation. In general, strategies to deal with systemic problems will entail individual bank liquidations as well as at least partial restructuring of a significant part of the banking system. Such a process involves a variety of complex decisions, including the determination of how the burden of the cost of the restructuring is to be shared, what instruments will be used for the restructuring, and what should be the role of the relevant government agencies. Thus, specific laws will be required to support the process. An important question is how much of the legal and institutional frameworks necessary to buttress systemic restructuring exercises should be put in place before those systemwide bank restructuring operations become necessary. In this particular context of the role of the central bank as lender of last resort, this question poses a delicate issue concerning the extent to which an approach of constructive ambiguity should be taken to preserve a measure of market discipline and contain moral hazard. There is, of course, no single or categorical answer on the desirability of such an approach. However, it is worth noting that ambiguous settings provide fertile grounds for politically motivated interference and for market-induced attempts to shift private risks to the public purse.

The design and implementation of a systemic bank restructuring strategy will involve various government authorities—at a minimum, the finance ministry, the supervisory authority, and the monetary authority (the latter two, of course, could be vested in the same institution). Consideration must be given to the need for legal rules to establish the respective responsibilities of these authorities and provide them with any needed special powers to carry out the systemic restructuring process. In sum, the subject of dealing with banks in distress is important, topical, and complex.

Chapter

8 Comparative Banking Supervision

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Evolutionary trends have fundamentally altered the business of banking over the last decade or so, and, consequently, bank managers have had to adjust their practices. Technological advances, product innovation, globalization, structural changes, and deregulation have all made the world of banking ever more complex, integrated, and competitive, and overall just a much tougher place to do business.

Not surprisingly, these trends have raised major new challenges for bank supervisors as well as all across the globe. Indeed, bank supervisors have witnessed a wave of broad-scale banking problems in a significant number of countries, both large and small, industrialized and developing. In their wake, serious questions have been raised in several countries about the adequacy of bank supervisory techniques and overall performance, and about the need for fundamental changes in supervisory approaches. Further fueling the forces for supervisory change—and for closer international supervisory cooperation—have been a number of high-profile, institution-specific problems, of which Barings and Daiwa Bank are the most familiar.

This chapter has three goals. First, it describes briefly the different types of supervisory models in use among the Group of Seven countries.[1] Second, it details the U.S. supervisory approach. In addition to describing the supervisory tools used in normal circumstances, it examines the U.S. approach in times of stress, such as the serious banking problems that arose in the United States in the late 1980s and early 1990s. Finally, this chapter deals with the work of the Basle Committee on Banking Supervision, including its pioneering efforts in the area of prudential risk-based capital requirements, its important work on risk management and internal controls, and its ongoing efforts to establish the principle of comprehensive consolidated supervision and to achieve close collaboration among bank supervisors and other financial regulators.

Bank Supervisory Approaches

Although supervisors around the world employ a host of different approaches in their oversight of banks, they share several common goals.

In addition, the overriding objective in all cases is to maintain public confidence in their banking systems.

A full and complete discussion of supervisory models in use by the Group of Seven countries would have to focus on several dimensions. The key dimensions would include statutory authority for the bank supervisory agency, including enforcement powers; the balance between formal regulations and less formal supervisory guidance; the nature of regulatory reporting, required public disclosures, and surveillance; the role of on-site examinations; and the supervisors' relationships with external auditors, the board of directors, and senior management.

This chapter concentrates on the latter two dimensions: the role of on-site examinations and the supervisors' relationships with external auditors. A closer look suggests that the Group of Seven countries fall generally into two approaches but along a fairly wide spectrum.

At one end of this spectrum are supervisors who rely primarily on their own on-site examinations to determine the state of a bank's affairs. At the other end are supervisors who rely heavily on the opinions and assessments of a bank's external auditors rather than on their own on-site examiners. The choice as to where one fits best on that spectrum can be influenced heavily by factors such as the size and distribution of the country's banks. In the United States, for example, there are over 9,000 commercial banks, and no one institution has more than 7 percent of the commercial banking market. In a number of other Group of Seven countries, several major banks typically dominate their national banking sector, accounting for as much as 80 percent to 90 percent of their total market.

Generally, the differences between countries are more a matter of degree than an "either/or" proposition. In addition, the commonalities are many and important. For example, in all cases bank supervisors will supplement their efforts through other supervisory tools, such as regular statistical reporting, off-site surveillance and analysis, prudential regulation, and an ongoing close dialogue with senior management. In addition, all of the Group of Seven supervisors have statutory authority to conduct on-site examinations if they see a need to do so and also have a variety of corrective and enforcement tools at their disposal.

Thus, while this chapter refers generically to two basic supervisory approaches, it should be clear that many variables are at play within each basic approach and that many overlaps exist between the two frameworks.

Examination Practices: On-Site Examiners

The Group of Seven countries that rely primarily on their own on-site bank examiners are Italy, France, Japan, and the United States. In these

countries, the foundation of the oversight process is periodic visits by examiners to banks in order to evaluate overall the financial condition and operational soundness, and to ensure compliance with banking laws and regulations.

The scope of supervisory surveillance in all four countries is quite similar, reflecting their common concerns—capital adequacy, asset quality, management quality, earnings, and liquidity. Also, in each of these countries supervisors provide guidelines that limit maximum bank exposure to any single borrower or group of borrowers.

Typically, on-site examiners make use of the bank's records and of their discussions with bank staff in order to gain a broad understanding of the bank's operations and management systems. They also may review the work of the auditors, particularly to note any exceptions that may have been identified. Based on an in-depth analysis of a great deal of detailed information, they assess the institution's condition. In all the countries except France, they use a structured rating system to ensure completeness and consistency in their assessments. In France, a similar, but less structured, assessment system is used.

In all the countries, when concerns or problems are identified, they are discussed with bank management. This can occur as part of the on-site examination process or in subsequent meetings.

The frequency of routine on-site visits varies among these countries. The Federal Reserve or other examiners in the United States visit banks at least every 12–18 months. In Japan, the banks receive full-scope examinations by the Ministry of Finance and the Bank of Japan every other year. In contrast, Italian and French examination schedules are typically less frequent. Italian banks used to be visited only every six to seven years, but this period is currently being shortened. In France, the frequency of examinations is a function of the size and condition of the bank. Smaller banks in sound condition receive a full-scope examination every four to five years, while troubled institutions might be visited annually. Larger institutions, however, are typically visited every year or two, although the examination focus will normally be targeted at specific areas, such as market risk or reserve practices.

Last and most important, supervisors in each of these four countries will conduct special on-site examinations if problems surface.

Examination Practices: External Auditors

In the second supervisory approach, the external auditors' opinions and findings are the primary input to supervisory assessments of the

financial soundness of a bank and to determinations of corrective actions that may be necessary. In special cases, the supervisors may commission experts to make assessments or may elect to make their own on-site visits. However, the scope of those visits will be quite focused.

For routine situations, banks are required to engage auditors to conduct various types of reviews specified by the supervisors, such as verifying financial controls and attesting to the financial statements of the audited bank. The auditors typically visit banks on a regular basis—annually or semiannually—and present their findings in reports that are shared with both supervisors and bank management.

In addition, the auditors may meet regularly with supervisors to discuss banking issues. In some cases, the supervisors may meet with the auditors directly, while in other cases only in conjunction with bank management. Auditors are expected to notify supervisors directly and promptly of any serious legal violations or other significant problems that are identified.

Given the importance of the role of auditors, it is not surprising that supervisors typically influence the choice of auditors. In some cases, banks may be required to choose auditors from a list preapproved by the supervisory authorities, and they may also be required to notify supervisors when they change auditors. In all cases, supervisors have the authority to remove or revoke the appointment of auditors if they believe that the auditors cannot perform their work satisfactorily, or if they have concerns as to possible conflicts of interest.

Two of the Group of Seven countries—the United Kingdom and Germany—fit the external auditors model rather closely. The United Kingdom, which has no full-time examiners and no routinely scheduled examinations, is probably the best example of this model. However, even in the United Kingdom bank supervisors will make on-site visits to banks from time to time to assess specific areas of special interest or concern. In Germany, the supervisory authorities are authorized to conduct on-site examinations but rarely do so. In normal circumstances, they, too, rely almost exclusively on the work of external auditors, although targeted examinations will be undertaken in special circumstances.

Canada seeks to strike a balance between the two basic approaches. Its examiners do, in fact, conduct annual on-site examinations, but the focus of the exams is on broader issues and process, with the transactional details left to the external auditors to verify. Thus, the Canadian authorities rely on external auditors to ensure compliance with applicable rules and regulations. The supervisors also regularly hire credit specialists to check a bank's loan files, and other types of specialists are hired as needed.

One final point regarding these supervisory approaches is that several of the Group of Seven countries seem to be adopting practices that are moving them closer to the middle of the spectrum. For example, the United Kingdom and Germany are making on-site visits to assess and validate the internal models that internationally active banks will be allowed to use in order to compute capital charges for market risk. Also, in other countries that rely on on-site examinations supervisors are increasing their use of external auditors. For example, recent legislation in the United States requires large- and medium-sized banks to have their external auditors attest that internal controls over financial reporting are effective.[2]

Examination Practices: Market Discipline

There is another possible supervisory model, at least theoretically. It is the market discipline or public-disclosure-based model. Here, the notion is that extensive public disclosure, and the ensuing market discipline, will provide incentives for bank managements to take risks prudently and to ensure that their banks remain in sound financial condition. The theory is that hands-on prudential supervision should be rendered unnecessary in such cases.

While no Group of Seven country has adopted this model, one country—New Zealand —has acted to implement this approach.[3] The Reserve Bank of New Zealand has eliminated most prudential regulations except capital adequacy requirements and limits on credit exposures to related parties, and replaced its regulatory reporting requirements with a new public disclosure regime. Banks must disclose on a quarterly basis detailed information, such as financial positions, asset quality and loan-loss provisions, concentrations of credit exposures, market risk exposures, capital adequacy, and information about their boards of directors. The disclosures must be signed by the banks' boards to attest to accuracy.

Even so, the Reserve Bank of New Zealand authorities have retained some practices associated with the other approaches. They continue to meet with senior bank management at least once a year. Also, they have increased the frequency of statutory external audits from an annual to a semiannual basis.

New Zealand implemented the disclosure framework on January 1, 1996. Thus, it is too early to try to assess its performance. It should be pointed out however that, given its rather unique circumstances, New Zealand is a very special case. Indeed, New Zealand has only a handful of large banks, all of which are foreign owned and all of which are subject to consolidated supervision from the respective home country supervisors. In such circumstances, it is clearly easier to opt for the market-discipline approach.

From this overview of comparative banking supervision, it should be emphasized that there is no single correct approach. For example, after the problems of Daiwa Bank[4] and Barings[5] surfaced, supervisors in Japan, the United States, and the United Kingdom were all criticized to varying degrees for the same weakness—inadequate supervisory oversight—even though very different supervisory approaches were followed in each of those countries. Similar observations can be made regarding the many countries that encountered severe real estate problems in the late 1980s and early 1990s.

What these experiences indicate is that no one is fully satisfied with current supervisory practices. Rather, the evolutionary trends have caused not just the banking industry, but also bank supervision, to be very much in a state of flux.

Common Themes in Supervisory Practices

As bank supervisors assess and continue to learn from their past experiences, three common themes that are emerging both in the United States and elsewhere can be detected.

The first theme suggests a noticeable shifting of emphasis in supervisory practices from detailed transactional reviews to a more risk-based and process-based focus. As the banking business becomes ever more complex and model driven, supervisors must rely to an increasing extent on assessing the adequacy of each bank's own risk-management practices and internal control systems. This shift has two implications. First, a bank's management is, more than ever, the first line of defense, and it must bear the primary responsibility for ensuring the bank's financial soundness. This is particularly important in today's high-technology environment, where risk exposures and consequent losses can develop so quickly. At the same time, supervisors will have to rely to a greater extent on a bank's own internal and external auditors to conduct detailed transactional reviews. This is likely to be increasingly true even in countries such as the United States that follow the on-site examination model.

The second emerging common theme is the trend toward broader disclosure and a greater reliance on market discipline. Banks in the Group of Seven countries, to varying degrees, are increasingly being encouraged by their supervisors to disclose publicly more detailed information, especially with respect to their risk exposures and management practices. While this trend is surely needed and to be supported, in the opinion of many observers market discipline cannot fully substitute for a hands-on independent bank supervisor, although it can play a very important complementary role. This point is elaborated on later in this chapter.

A third common theme is the welcome trend to apply common prudential standards and requirements across national boundaries. The most prominent example of this trend is the 1988 Basle Capital Accord,[6] which set minimum capital requirements for banking organizations from the major countries with cross-border operations. Increasingly, these standards are being adopted by countries around the world. Even financial institutions not required to follow the guidelines are tending to do so voluntarily as a way of gaining favorable market standing.

Common standards are also being applied internationally through the identification and adoption of sound practices covering a variety of areas. Such efforts identify broad policies and procedures, leaving it up to the individual countries to determine the specifics of implementation, by taking into account their own legal, institutional, and accounting structures. A good example of common standards is found in the guidelines issued by the Basle Committee in 1997 that sets forth principles for the management of interest rate risk.[7]

The U.S. Approach

In examining the U.S. approach to bank supervision, this part first focuses on how U.S. bank supervisors function during "normal" times and then during times of stress. The dual banking system in the United States—under which banks can obtain either federal or state charters—has resulted in a complicated structure of bank supervision. Several official supervisory agencies are involved, including the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve, and 50 individual state banking authorities.[8] While there are some differences in supervisory techniques, they do not vary greatly from agency to agency. Moreover, the agencies consult with each other and, under the aegis of an interagency working group, the federal agencies try to coordinate their practices and regulations. In addition, 1994 legislation required the federal agencies to develop standards for unified examinations by October 1996.[9]

As previously mentioned, the cornerstone to ensuring the safety and soundness of U.S. banking organizations and their compliance with laws and regulations is the on-site examination process. U.S. bank supervisors have found that a meaningful presence in a bank enables them to gain a detailed knowledge of the bank's operations, procedures, controls, and management, which is invaluable in reaching an informed judgment about the bank's overall condition.

During on-site reviews, the examiners carefully evaluate the institution in a number of critical areas.[10] This review results in a formal composite rating that summarizes the bank's overall condition. The exact components of the rating systems vary according to the type of institution being examined, whether a bank, a bank holding company, a foreign branch, or other entity. However, in each case the rating system is designed to identify significant supervisory concerns systematically and consistently.

While U.S. bank supervisors regard on-site examinations as essential to the supervisory process, they, of course, can provide only snapshots of the banking institution. In order to fill in the supervisory picture between annual examinations, U.S. bank supervisors rely heavily on regular statistical reporting and in-house surveillance and monitoring. For example, every quarter banks file what are commonly known as "call reports," which provide extensive information on the structure and maturity of the bank's assets, liabilities, and capital, as well as on its sources of revenue and expense.[11] These reports also provide information on a bank's nonperforming and potential problem assets, its off-balance sheet activities, and its contingent liabilities.

Through the call reports and other regular reports, as well as risk-management reports made available by the largest banks, U.S. bank supervisors have access to a wealth of information that is subjected to in-house surveillance and analysis and that allows for dynamic monitoring of banks' financial conditions throughout the year. It enables the supervisors to identify banking institutions that, while currently healthy, may be facing specific problems down the road. Surveillance techniques may also allow supervisors to spot adverse industry trends and to address more generic problems before they become critical or unmanageable.

U.S. bank supervisors typically supplement in-house surveillance with regular meetings with bank management. They want to know the banks' managers and to be able to work closely with them. Maintaining ongoing contacts should result in fewer surprises for everyone. In the long run, effective supervision should be, and has to be, a cooperative process, although appropriate enforcement action can be resorted to if the need arises.

Not surprisingly, in situations of stress the efforts of U.S. bank supervisors become more intense. In cases of significant problems, the supervisors require banks to report additional detailed financial information on a quarterly, monthly, weekly, or even daily basis.[12] In such cases, meetings with bank management also intensify; the supervisor may undertake additional examinations and may require the bank to submit a business plan to address its problems.

If the situation were to continue to deteriorate rather than to improve, the U.S. bank supervisor might well encourage, or require, the bank to take additional, and perhaps more painful, corrective actions. This close hands-on supervisory scrutiny would continue until the bank's financial condition fundamentally changed; asset quality and any other difficulties, such as internal controls, improved; equity and reserves were restored; and there was a sustained improvement in core earnings.

Managing Bank Crises in the United States

The Federal Reserve had extensive experience in crisis management of banks, including several of the largest in the United States, in the late 1980s and early 1990s. The following is a summary of how the Federal Reserve worked with a number of these banks to resolve some serious problems. While the situation varied from bank to bank, the general approach of the Federal Reserve was quite similar.

Net charge-offs at the largest bank holding companies rose steadily throughout the 1980s. This deterioration was reflected in bank balance sheets that had been weakened by the combined effect of the less-developed countries' debt problem; loan concentrations to troubled sectors such as energy, agriculture, and shipping; and the commercial real estate problem that surfaced in the late 1980s.

During this period, examiners at the Federal Reserve observed a sharp deterioration in asset quality, with spillover effects on earnings and capital. They also saw signs of deterioration in the internal control environment at several of the banks. In response, examiners noted their concerns in examination reports and downgraded regulatory ratings of individual banks. The initial response of bank management to the downgrades was typically one of denial. However, as the situation continued to worsen and supervisory comments intensified, most senior bank managers, to their credit, came to recognize the potential seriousness of the situation.

At the request of the Federal Reserve, the banks prepared detailed financial plans describing how they proposed to address their various problems. Reflecting both the Federal Reserve's and their own initiatives, the plans submitted to the Federal Reserve included:

- the raising of significant amounts of new capital;
- the aggressive write-off of bad loans;
- strict limitations on asset growth;
- the sale of poorly performing assets and unprofitable business lines;
- a sharp reduction in operating expenses, primarily through large staffing cuts;

- the development of contingency funding plans in the event of liquidity problems;
- the reduction or, in some cases, the total elimination of dividends;
- more active involvement by the bank's board of directors and, in some cases, changes in senior management; and
- from a contingency standpoint, the consideration of possible merger candidates as a last resort.

While going through this crisis period was a difficult challenge both for the bankers and their supervisors, the program worked well. Once the bankers accepted the severity of their problems, they moved aggressively in partnership with the supervisors. By most measures—such as asset quality, capital adequacy, and earnings—these banks managed to recover in a period of just a few years.

In retrospect, perhaps the principal lesson to be learned from the U.S. experience is that when supervisors see storm clouds on the horizon, or worse yet forming directly overhead, it is imperative that they move quickly to get bank management's full attention and their recognition of the need for prompt remedial action. History has shown time and again, in the United States and elsewhere, that the longer an institution waits to address the problem, the harder it will be to manage. Unfortunately, the temptations to try to muddle through can, at such times, be almost irresistible.

Prudential Policies

Another key element of the U.S. approach to supervision is the development and administration of prudential policies. The purpose of such policies is not to micromanage banks, but rather to ensure that the banks are operated safely and soundly and in a manner that appropriately serves the credit needs of their communities.

There are three principal areas where U.S. bank supervisors have implemented extensive prudential policies:

- capital adequacy;[13]
- asset concentrations;[14] and
- risk management and internal controls.[15]

Since capital policies are well known, this part focuses on the last two areas: asset concentrations and risk management.

Prudential regulation regarding asset concentrations is particularly important because credit risk concentration has been at the core of most

significant banking problems encountered in the United States and elsewhere for a very long time. The dangers of excessive credit risk concentrations have long been recognized in U.S. banking law through a statutory limit on loans to individual borrowers (which is currently set generally at 15 percent of bank capital).[16]

However, concentrations can also occur in less visible, but just as dangerous, forms, such as on an industry-wide basis. For example, in the 1970s and 1980s loan concentrations to the energy, agriculture, shipping, and commercial real estate sectors resulted in significant problems in the United States. Similarly, the current Japanese banking crisis can be attributed in large measure to very heavy real estate loan concentrations, as can the banking problem in Sweden.[17]

Concentrations can also arise by geographic region or as a result of risks that may be common to a particular type of borrower. The financial and economic difficulties shared by many less-developed nations in the 1980s is a clear case in point. The explosive growth in leveraged buyouts and other types of highly leveraged financing in the mid-1980s also comes to mind.

While the loans were made to different firms in different industries and in different geographic areas, they were still a form of loan concentration because they shared a common vulnerability under certain economic and interest rate scenarios. When rising and potentially dangerous levels of asset concentration are detected, whatever the form, U.S. bank supervisors will act to focus bank management's attention on the issue, encourage them to set limits to curb growth and monitor developments closely.

In the United States, recent trends involving consumer credit and capital-markets activities could give rise to new patterns of concentration not seen before. Clearly, an important task for both supervisors and bank managers alike will be to detect such potential problem areas as early as possible and to make sure that appropriate defensive measures are taken.

Turning to the Federal Reserve's prudential policies in the risk-management area, the Federal Reserve has—along with many other supervisors around the world—increased its emphasis on sound risk-management practices and strong internal controls when evaluating the activities of banks. Such systems and controls are absolutely critical to the prevention or detection of mismanagement and fraud, and to the conduct of safe and sound banking activities. Surely, this is one of the most obvious and basic lessons to emerge from the Barings and Daiwa Bank cases.

As noted at the outset, bank supervision is not, and cannot be, a stagnant process. As the banking industry evolves, bank supervisors must

continually seek ways to improve their methods and practices so as to better respond to the ongoing changes in the nature of banking. As a part of this process of review and self-appraisal, the Federal Reserve established an internal committee to conduct a comprehensive review of the financial examinations process. The committee's task was to make recommendations to help preserve the best aspects of the existing process while identifying ways to improve its effectiveness and efficiency in the future. The committee's basic conclusion was that the recent trend to more risk-focused and process-oriented examinations should be accelerated wherever possible. This recommendation, which is now being fully implemented, carries important implications for all aspects of the Federal Reserve's examination process. Moreover, the international supervisory community will also be moving in this direction over time.

International Initiatives of the Basle Committee on Banking Supervision

The Basle Committee on Banking Supervision is composed of supervisors from the Group of Ten countries. The committee monitors international banking developments and trends and tries to ensure appropriate supervisory responses. The committee's goal is to promote supervisory cooperation, to improve the quality of supervision worldwide, and to close existing gaps in supervisory coverage. Hence, the emphasis is on broad prudential issues rather than on specific supervisory techniques.

Capital Adequacy: The Accord

The single most important contribution of the Basle Committee to date is the Basle Capital Accord.[18] This agreement sets out in detail a framework for measuring capital adequacy on a risk-weighted basis and a set of minimum standards that would be applied consistently to all major international banks in the Group of Ten countries. The goal was to create a consensus framework that was both reasonable and prudent, and that would provide competitive equality among internationally active banks.

Initially, the Basle Capital Accord focused on capital adequacy solely in relation to credit risk. However, it was understood from the beginning that other types of risk, particularly market risk, would eventually be incorporated into the capital standards as banking institutions developed their trading businesses and their exposure to market risks expanded.

Dealing with market risk was a major challenge but, in January 1996, the Basle Committee finally approved a proposal to incorporate this risk into the risk-based capital framework.[19] Under the proposal, which was

implemented at year-end 1997, capital charges will be applied to cover the risk of losses in both on- and off-balance-sheet positions emanating from market price changes. An exciting feature of this amendment, and a precedent-setting innovation in supervisory practices, is that it will allow banks to compute their capital charges using their own internal market risk-measurement models. The amendment reflects extensive consultations with the industry and its concerns that a standardized measurement framework, as initially proposed,[20] would not be sufficiently compatible with the banks' own measurement systems, would be costly to implement, and might retard risk-management innovation in the industry.

Looking to the future, with the ink now dry on the market-risk proposal, consideration is being given in some quarters to the question of how to approach total capital over the longer term. Some intriguing ideas have been put forward by researchers, basically putting more of the onus on individual banks to determine prudent amounts of capital and to be penalized in some way for misjudgments. These ideas are now just in their infancy. However, they are indicative of supervisor awareness and acceptance of the evolutionary nature of the supervisory process.

Accounting Standards: International Harmonization

The Group of Ten supervisors are discussing the need to work toward a harmonizing of international accounting standards. This is an area where the Federal Reserve thinks that much useful work needs to be done. It is important work because without such harmonization it is far from clear how successful bank supervisors have been in achieving a level playing field regarding international capital requirements. For example, if international banks are using disparate accounting methods for key capital elements, such as for determining loan loss provisions, past due loans, and income and expenses, it is unlikely that the capital ratios derived will afford a reasonable basis for comparison across countries.

Thus, ultimately, a common set of accounting conventions is needed to make sure that bank supervisors and the market are not comparing apples and oranges, and are able to make meaningful financial assessments of firms and useful comparisons from their public disclosures. No one should have illusions as to the magnitude of this task. Achieving international harmonization of accounting practices is likely to be a very slow and tedious process because there are many participating countries and entities with different traditions, laws, priorities, and concerns. However, participants must not back away from this challenge. Without greater convergence, the full potential benefits of the Basle Capital Accord will not be fully realized.

Consolidated Supervision

Increased globalization of banking is also bringing to the forefront the critical importance of consolidated supervision. As cross-border activities grow, it is essential that no internationally active banking establishment escape supervision and that the supervisory oversight be on a comprehensive and consolidated basis. Failure to achieve this can have disastrous consequences, such as those that occurred with the Bank for Credit and Commerce International.[21]

To achieve this objective, the relative roles and interrelationships between supervisors in the home country (that is, the jurisdiction where the parent is organized) and the host country (where the local activity to be supervised is conducted) need to be defined clearly.

In June of 1992, the Basle Committee addressed this issue in a paper, setting forth "Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments."[22] Four key standards were agreed upon at that time.

- First, it was agreed that all international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision. To this end, the host supervisor was responsible for determining that the home supervisor had the capability to perform consolidated supervision, taking into account the home supervisor's statutory powers, past supervisory experience, and the scope of its administrative practices.
- Second, it was agreed that, before commencing operation, cross-border banking establishments should receive the prior consent of both the host and home supervisors. The Basle Committee saw the authorization process as an ideal opportunity for home and host supervisors to share information and establish a foundation for future information exchange and supervisory coordination. Furthermore, they recognized the authorization process itself as the supervisory cornerstone in preventing the establishment of questionable banking operations deemed likely to cause trouble.
- Third, it was agreed that home supervisors should possess the right to gather information from the cross-border banking establishments of their banks. This information gathering could be done either through on-site examinations or by other means satisfactory to the home supervisor—presumably based on the particular supervisory approach that was being followed.
- Fourth, the Basle Committee agreed that if a host supervisor determines that any one of the foregoing minimum standards is not being

met to its satisfaction, it could impose restrictive measures as necessary to satisfy its prudential concerns, including a prohibition on the creation of new banking establishments.

It may seem that these are fairly straightforward standards that appeal to both common sense and reason. In fact, while virtually everyone agreed in principle to the minimum standards, implementation has not been easy.

The crux of the problem is that consolidated supervision requires the free flow of relevant information between host and home country supervisors. For a variety of reasons, information has not been flowing as freely in either direction as one might have hoped.

Why have supervisory authorities been reluctant to share information? In many cases, host authorities have faced the major constraint of a lack of resources, particularly staff resources, to gather properly supervisory information. In some cases, the host authority may be uncertain as to what information would be relevant and useful to home supervisors, perhaps because of meaningful differences in supervisory practices and approaches.

Home supervisors, on the other hand, find it difficult to share information with host supervisors at times when their banks are experiencing serious financial difficulties. At such times, the focus of the home supervisors inevitably will be on trying to find a viable solution to their banks' problems. In such circumstances, home supervisors will almost certainly be reluctant to share information on a bank's condition with a significant number of host supervisors and thereby risk precipitating the very crisis that they are trying to prevent.

All of these problems can be very real, but by far the most significant information-sharing obstacle that bank supervisors have had to contend with is the bank secrecy laws that continue to exist in some jurisdictions.[23] While limitations on disclosure of customer information are usually directed at deposit balances—an item that is normally not of major interest to supervisors—some banking centers extend their secrecy requirements to asset information as well. Moreover, some bank secrecy laws even prevent home country supervisors from performing any on-site examinations of local offices of banks for which they are the consolidated supervisor. Such laws are totally at odds with the principle of consolidated supervision that bank supervisors have been attempting to implement.

To address this problem, a joint working group was formed of members from the Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors, the latter primarily representing a group

of countries that are not members of the Organization for Economic Cooperation and Development, and many of which have some form of bank secrecy law. The joint group has produced a paper that, among other things, establishes three important principles.[24] First, home country supervisors should be able to conduct on-site examinations of overseas offices of their banks, and bank secrecy laws that interfere with their ability to do so should be changed. Second, home country supervisors should be able to gain access to depositor account information at overseas offices of their banks if needed for safety and soundness purposes, including the pursuit of suspicions of serious criminal activity by banks or their customers. Third, evidence of serious violations of home country criminal laws uncovered during such on-site examinations can be passed by the home country supervisor to the home country's law enforcement authorities as may be required by the home country's laws. The paper was endorsed by bank supervisors of 130 countries at the International Conference of Bank Supervisors in 1996. Fully implementing these principles will take considerable time and effort, but, given the need for changes in local laws and local customs, getting the principles agreed to and on paper is a critical first step toward making comprehensive, consolidated supervision a global reality.

A description of consolidated supervision would be incomplete without a few words on the current efforts of the Basle Committee to coordinate their efforts with supervisors of other financial institutions, such as securities and insurance firms. The blurring of distinctions between banks, securities firms, and insurance companies has given rise to a proliferation of global financial conglomerates that offer a wide variety of financial services. The concerns expressed with respect to the supervision of cross-border activities of banks are fully applicable to financial conglomerates as well and make it increasingly necessary that supervisory collaboration between all relevant financial supervisors be improved. This effort has been under way for some time.

In June 1995, the finance ministers of the Group of Seven countries, at a meeting in Halifax, Canada, took note in their official communiqué of the growing importance of increased supervisory collaboration between banking and securities supervisors.[25] In response, the Basle Committee and the International Organization of Securities Commissions (IOSCO) have affirmed their common goal of improving the quality of supervision worldwide and responding to financial market developments in a timely, effective, and efficient manner.[26] In pursuit of closer collaboration, the Basle Committee and IOSCO have engaged in ongoing efforts to achieve more consistent regulatory treatment in cases where banks and securities companies are participating in similar types of activities.

It is worth noting that the collaborative efforts are spreading to insurance supervisors as well. In July 1995, the Tripartite Group of Bank, Securities, and Insurance Regulators issued a report suggesting several areas for further study.[27] Among other things, they agreed that supervisors needed to assess the capital adequacy of diversified financial conglomerates on a consolidated basis.[28] However, they also recognized the usefulness of a "solo-plus" approach that looks both at the individual entities as well as at the group as a whole.[29]

The Tripartite Group's report also stressed the importance of close cooperation between the various supervisors responsible for the different components of a financial conglomerate and the need to exchange prudential information among themselves.[30] To this end, they suggested consideration of the appointment of a "lead supervisor" or "convener," whose responsibility it would be to gather all relevant information, including information on the group's nonregulated entities, and to pass that information, as appropriate, to other concerned supervisors.[31]

To maintain the momentum generated by the initial work of the Tripartite Group, a new group composed of banking, securities, and insurance supervisors was appointed and designated the "Joint Forum."[32] The work of the Joint Forum is ongoing and, among other things, it seeks to develop proposals for better collaboration, including the possibility of adopting a lead-supervisor approach. It also plans to establish a code of principles for effectively supervising financial conglomerates, including such issues as how to measure group capital, control intragroup exposures, and limit the potential for contagion within a group. Obviously, this is an ambitious agenda and is sure to result in an active and extended dialogue. Difficult issues remain to be tackled and resolved, particularly with respect to the proposal for a lead supervisor. A number of questions arise in this regard. For example, which financial firms should be covered by the proposal? What criteria should be used to decide which supervisor should be designated as the "lead?" Should the lead supervisor's role be confined to receiving and sharing information, or should the role be more broadly defined? Which host supervisors should be included in the information-sharing network? What information should be shared? And, crucially important, how will this be done without creating new bureaucratic problems?

Everyone involved in the Joint Forum's work recognizes that much give and take will be needed if meaningful progress is to be achieved. However, success at the end of day is likely. A way must be found to supervise effectively global financial market participants if the challenges posed by the major global trends currently under way in the financial industry are to be met.

Conclusion

It is clear that the role of the bank supervisor is under examination in many countries and that there will no doubt be important changes, as individual countries continue to adapt their supervisory approaches. The role of capital requirements, the contribution of external auditors, and the importance of market discipline will all evolve further. Whatever happens, it will be clear to all that none of these alternatives can fully substitute for the role played by the bank supervisor.

The basis for this conclusion is that the firm's management, the marketplace, and the official supervisor, each in its own way, has something special to offer. There are unique comparative advantages of each. As previously noted, a firm's own board of directors and senior management—and the checks and balances they build into their organizations through internal controls, limits, internal audits, and progressive levels of review by independent functions—are the first and most important line of defense. Media headlines have illustrated the fate that awaits institutions that fail to heed this lesson. At the market level, oversight takes the form of what is typically referred to as market discipline. Undeniably, efforts to achieve better public reporting and disclosure and more consistent international accounting standards would help considerably to enhance market discipline. Greater transparency can enable market participants to make more informed judgments about those with whom and to what extent they are prepared to do business. All steps in this direction should be strongly supported. However, firm- and market-driven supervision are simply not enough.

Bank supervisors possess their own special and unique comparative advantages. First and foremost, bank supervisors are far better positioned and more inclined to focus attention on systemic risk and other important and longer-term public policy issues than the individual firm or the broad marketplace that focuses necessarily on shorter-run financial performance.

Second, bank supervisors have undeniable advantages in obtaining and assessing certain types of information. For example, they have more extensive and more timely access to sensitive information than markets are ever likely to have. By virtue of their supervisory authority, they have direct and immediate access to proprietary information on all the banks that they supervise, including their management information systems and internal control environments. In addition, bank supervisors have the unique ability to compare any bank's management and control processes, as well as its financial performance, against that of its peers. The work that bank supervisors have done recently on internal models in connection with the market-risk proposal[33] is a good case in point.

Third, experience strongly suggests that bank supervisors are also needed to enforce compliance with applicable laws and regulations both in good times and in bad.

Finally, only bank supervisors have the requisite knowledge and clout to ensure that prompt corrective actions are taken when serious financial or other problems are identified. The critical role that can be played by a supervisor in problem cases—both through public enforcement actions and through other far less visible means—cannot be overstated.

While both firm and market-level oversight should be strongly encouraged and supported, there continues to be a prominent role for bank supervisors as well. The challenge for bank supervisors is to continue to adjust quickly in response to the evolutionary trends affecting the banking industry. Much has been done on both the domestic and international fronts, and more efforts are currently under way.

COMMENT

HENRY N. SCHIFFMAN

Legal Aspects of Bank Insolvency

Banks are highly regulated because of the nature of their liabilities—the savings of the public—and banks also provide the medium of the payment system; consequently, bank insolvency must be managed somewhat differently than the actual or impending insolvency of an industrial or commercial enterprise. Thus, the law should have distinctive provisions providing for the reorganization of a bank facing actual or impending insolvency.

The best methods for restructuring the finances of a bank are usually the purchase by another bank of the troubled bank, or some of its assets and the assumption of its liabilities, and the infusion of new capital. For a bank, these matters are so closely connected with regulatory considerations that it would be inappropriate for depositors (the predominant creditors) or the courts (which have little expertise in financial analysis of bank assets and in bank supervision) to have the same legal authority to determine the outcome of the insolvency as creditors and the court have in an enterprise insolvency. Expertise may, in a given country, be limited to a few qualified conservators and the bank supervisory authorities.[1] Nevertheless, if there are suitable liquidation provisions in a country's insolvency law, then the receivership functions could be performed, consistent with bank supervisory authority guidelines, under supervision by the bankruptcy court.

The distinctive provisions for bank insolvency in the banking or insolvency law would be intended for a country that has a reasonably sound banking system and only occasional bank failures, rather than for a country in which the fragility of banks' conditions is systemic and where government funding, among other things, will be required to resolve the banks' problems. For the latter situation, there could be a special law on bank rehabilitation that apportions the burden of losses among depositors, other creditors, shareholders, and the government. However, the general provisions of a bank insolvency law should not preclude bank recapitalization. In the absence of any special law on bank insolvency, losses should be apportioned in a liquidation as provided in the section of the general insolvency law that contains priorities in the distribution of proceeds from the sale of the insolvent's assets.

The objective to be realized in managing a bank insolvency should be clearly defined and serve as a guidepost for actions of the bank supervisory authorities, conservators, and receivers. While the government, the bank supervisory authorities, the bank's management, the shareholders, the depositors, and the other creditors may have different objectives, as a legal matter the primary objective should be protection of the interests of creditors. In some countries, the law is clear that when a company becomes insolvent the duty of the directors of the company is to protect the creditors rather than the shareholders.[2] The law can explicitly provide for this objective. The powers of conservators and receivers should be designed to maximize the value of assets or have the liabilities assumed by a sound bank in the interest of creditors.

An appropriate insolvency law could provide that, if a bank is critically undercapitalized or faces actual or imminent insolvency, it should be liquidated in most cases in the interest of depositors and other creditors. This is based on the premise that its owners and managers had the responsibility to maintain the solvency of their bank and that supervisory remedial actions, by which they have been invited to maintain the bank's capital adequacy, will have preceded a decision to place a bank in conservatorship as a prelude to receivership.[3] In many cases, remedial measures may have failed or the time for their use may have passed. The challenge for bank supervision policy is to overcome the moral hazard arising from formal government-administered bank supervision, deposit insurance (where it is in effect), and a widely held belief that the government will make whole the losses of depositors in distressed banks often by rescuing the bank itself. Thus, there is a need to strengthen market discipline to overcome moral hazard. Depositors do not usually exert such discipline because they lack information or they are complacent. Shareholders have the best prospect to exert a salutary external influence on their banks, and, while this is still rare in most countries, it is to be encouraged. To this effect, the law should not provide special favorable treatment of bank shareholders. To the contrary, the provisions of the law should be a warning to shareholders that if their bank becomes insolvent, they risk losing control over the bank and their financial interest. This strengthens the credibility of the less intrusive supervisory remedial measures that will ordinarily be taken when a bank's capital declines.

A remaining issue is whether those who were the shareholders at the initiation of a bank conservatorship should be able to benefit to some extent from the actions of a conservator in rehabilitating or selling a bank. One consideration is that shareholder governance, except in a few countries and only in the past several years, is largely theory rather than practice. Thus, the question is whether the shareholders should be made to suffer unduly for the sins of management. It may be unlikely that

shareholders of a distressed bank will get a "free ride," because if rehabilitation is the result of recapitalization and if the shareholders do not inject new equity capital, their interest will probably be significantly diluted. If a bank is sold to another bank when not insolvent, the shareholders of the insolvent bank would be entitled to some consideration. However, again, if the market economy is working, the price paid for existing shares is likely to be less than the shareholders' investment and, if paid in stock of the acquiring bank, their interest in the new organization may be diluted to less than the proportion that the assets of the distressed bank represent in the new organization.

Consideration should be given to whether the bank insolvency law should provide only for the sale or liquidation of banks that are critically undercapitalized or insolvent, because this may be too harsh (especially for banks in existence at the time such new legal provisions take effect) and politically inexpedient. Banks facing actual or imminent insolvency should perhaps have the prospect of reorganizing under the management of a conservator if the bank supervisory authorities determine that this should be attempted for a limited period of time. No time, however, should be lost in liquidating a bank when the bank supervisory authorities determine that revocation of the bank's license and liquidation are clearly the proper actions.[4] The reorganization of a bank may include the injection of new capital by existing or new shareholders and either the retention or replacement of existing management, depending upon the determination of the conservator as to what is feasible in the interest of protecting the depositors and other creditors.

There are four basic actions that may be taken in dealing with a financially distressed bank: (i) rehabilitation; (ii) sale or merger of the bank as a going concern; (iii) asset sales and assumption of liabilities on a wholesale basis in the context of downsizing or liquidating the bank; and (iv) liquidation, in which case the assets will be sold in pieces, and depositors' and other creditors' claims will be resolved in winding up the bank. The distinction between conservatorship and receivership is as follows: conservators would manage options (i) , (ii), and (iii), and receivers would be concerned with options (iii) and (iv).[5] Unlike the situation in the Group of Ten and other industrialized countries where actual or imminent bank insolvencies are resolved by the purchase of the distressed bank by a strong bank, in some countries it may be extremely difficult to rehabilitate an insolvent bank without substantial government funding. Banks in transition economies generally have been deeply insolvent (beyond remedy through a change in management and policy) because of the financial condition of the enterprise borrowers. Thus, rehabilitation by virtue of conservatorship would probably occur in such countries in only a small fraction of the cases of bank insolvency.

Essential provisions of a law on bank conservatorship and receivership are those regarding the

- determination, on an objective basis, of the events that will give rise to the initiation of a bank conservatorship by the bank supervisor;
- definition of the objectives of a conservator and a receiver;
- criteria for determining whether a conservator or receiver is to be appointed;
- strict time limits for actions of the conservator, the receiver, and the bank supervisor;
- conservation of a bank's assets;
- powers of the conservator and receiver;
- limitation on opportunities for appeals by shareholders and creditors;
- rules for the distribution of assets in liquidation appropriate for bank insolvencies;
- standards of integrity for conservators and receivers;
- standards for determination of appeals;
- legal protection provided for actions of a conservator and receiver; and
- exclusive jurisdiction over claims arising from a bank insolvency.

The provisions of law that may govern a bank insolvency can be complex. For some countries, an important objective is to keep both the legal text and the requirements for the actions of a conservator or receiver as simple as possible. It is useful to limit discretionary determinations by the bank supervisor and by a conservator or receiver, under the policy that action is preferable to inaction in dealing with a distressed bank because delay generally leads to increased losses. Time limits for actions are desirable for the same reasons. The rehabilitation or liquidation process might be left predominantly to the conservator or receiver so as not to encumber the process, rather than referring many steps to a court for approval or permitting frequent court intervention, as is common in countries with courts equipped to handle complex commercial transactions. The purpose in having recourse to courts is for expert and impartial determinations. However, if there is a strong likelihood that court decisions will not satisfy both of these objectives, then it would seem better to have expert determinations by the bank supervisory authorities, even though there is some risk of loss of impartiality. The law could provide for registering before a court objections to placing a bank in conservatorship or receivership as the sole role for the courts in relation to a bank insolvency.

Consideration should be given as to whether traditional provisions in commercial bankruptcy law, such as those regarding an automatic stay of claims against the debtor, executory contracts, and the avoidance of certain prior transactions should apply to a bank conservatorship (as distinguished from a receivership). Arguably, these traditional provisions for enterprises should apply only partially to a bank conservatorship. With respect to a stay of claims, if a bank's prospective failure to pay its short-term obligations is permitted by the law, its chances of obtaining funding at anywhere near the level of the past would be diminished greatly when it is experiencing difficulties. Consequently, its chances of reorganization would also be diminished. Thus, it may be presumed that if it appears that a stay on creditors' actions or a freeze on deposits would be necessary to keep the bank in operation, such bank may not be worth keeping in conservatorship but rather should be placed in receivership because it is not likely to be viable.[6]

Executory contracts are those that have not been substantially performed by both parties. To decrease the workload of the conservator and not complicate the relations of banks with suppliers, not all such burdensome contracts should be subject to rescission, only those leases in which the bank is lessee. These should be among the most important contracts for banks in monetary terms. The law should also contain a provision to prevent the cancellation of utility services so that banks in conservatorship can continue to operate. A range of avoidance powers should be given to the conservator, including the power to avoid insider and gratuitous (including fraudulent) transactions, since these are traditional voidable transactions in bankruptcy and also are often important reasons for bank distress. Unwinding these types of transactions deemed to be unfair to creditors should not discourage funding from the public and may be important to recover assets of the bank and to improve its prospects for rehabilitation or sale.

The following hypotheticals raise further legal issues regarding bank insolvency laws.

Hypothetical Cases Regarding Legal Considerations in Bank Insolvency

Bank A is suffering severe liquidity constraints. Its asset quality problems over the past two years have caused its management to decide to pay well above prevailing market rates to attract extraordinarily large amounts of medium-term deposits to fund additional assets in an effort to grow out of its problem, but this has not been successful. Its liabilities primarily consist of 60 percent household deposits (more than half of which are

in amounts above the deposit insurance limit) and 30 percent liabilities to enterprises and institutional investors (banks and investment funds).

Hypothetical Number 1

Bank A defaults on the payment of principal on a one-year note issue whose principal amount represents approximately 8 percent of its total liabilities. Investment Fund B, which holds a large portion of the notes, files a petition under the applicable law to initiate an insolvency proceeding with respect to Bank A.

Should an insolvency proceeding be commenced based on these facts? What is the applicable law? If a proceeding should not be commenced, what further facts would justify the initiation of such proceedings?

Hypothetical Number 2

In an insolvency proceeding concerning Bank A that is properly initiated, the law provides that a reorganization or rehabilitation may be effected if creditors holding a majority of the claims approve a plan of reorganization. Bank A presents a plan to all its depositors and other creditors that provides for all household depositors to be paid in full, including interest due, and for other creditors to receive 40 percent of the amount of their claims. The plan is approved by depositors and other creditors holding 55 percent of the claims. Should a reorganization be effected?

COMMENT

JORGE Q. GUARDIA

Improving bank supervision has become an endless endeavor for policymakers, bank supervisors, bankers, economists, and lawyers. Much is to be gained by comparing banking laws and regulations, practices, and experiences from different countries with various degrees of financial development and institutional expertise. The following questions are of concern to a central bank counsel:

- What are the purposes of bank supervision?
  - to protect shareholders against bank managers;
  - to protect depositors against shareholders and bank managers;
  - to protect depositors and creditors;
  - to prevent bank failures and financial distress;
  - to prevent systemic risks;
  - to protect the banking system as a whole; and/or
  - none (all) of the above.
- Should the above purposes be stated explicitly in the law?
- To what extent should bank behavior be regulated by market discipline (public disclosure)? Are interest rates free to permit the proper functions of the market system? Is there any deposit insurance scheme that involves a moral hazard for investors, creditors, or depositors? What aggregate information must bankers publish and how often? Do government officials or the central bank dictate credit policy? Is banking business open to competition? Can foreign banks open subsidiaries or branches on a competitive basis?
- Are bank supervisors subject to political pressure? Are they legally protected? Can they be dismissed without legal cause? To what extent are they personally immune from litigation in connection with their duties?
- Should banking business be open to anyone so as to stimulate competition? What are (should be) the limitations, if any, to open a local bank or for foreign banks to operate a banking business through a branch or subsidiary?
- Under what circumstances may a banking license be revoked?

- Modern banking legislation requires banks to maintain a minimum ratio of capital to risk-weighted assets. Is there need to require in addition a minimum capital? What should be the required minimum capital for a bank? Should it be possible for this minimum to be modified without legislative approval?

- The Basle Committee on Banking Supervision has recommended a capital ratio of 8 percent to risk-weighted assets for banks of the Group of Ten countries engaged in international banking activities.[1] What reasons would justify a higher or lower ratio? Should the law or regulations require banks to reflect in this ratio (or another ratio) market, interest rate, foreign exchange, and other economic risks? How is "capital" or "net worth" defined?

- Should capital and other prudential requirements be stated in the law or, alternatively, in the regulations? Should there be constitutional limitations with respect to "delegation of powers" from the legislative to the executive branch in this area?

- As banking business develops and becomes more competitive, banks are forced to explore new and sometimes riskier activities. Should the scope of banking business (that is, the definition) be expanded? Should banks be permitted to venture into banking-related activities and hold shares of other enterprises? Should any additional activities be accompanied by higher capital requirements and provisions?

- Are banks subject to antimonopoly laws? Should a supervisory authority be allowed to intervene to prohibit bank concentration? What should be its legal powers? What should be the maximum percentage of shares in the capital stock of a bank that a person or group of persons is allowed to hold? Should substantial transfers of stock be monitored by the authorities?

- Should banks be administered by a single person (for example, a general manager) or by a committee?

- What should be the credit limits that banks can extend to single or related persons (credit risk concentration)? How should "related persons" be defined? Should the concept be extended to geographical areas or economic activities?

- Should liquidity standards be required as a proportion of the value or change in value of the bank's assets or liabilities? Should the supervisory authority be empowered to accept the bank's own computerized programming and internal control systems in this area? What should be the legal consequences for violations of such programming or control systems?

- Should the central bank or the supervisory authority be empowered to prescribe the level of interest rates and charges and to determine the credit policies as well as the classification and evaluation of bank assets?
- Commercial banks are normally subject to limitations on their foreign exchange operations. Should such limitations be used as a monetary instrument to control the foreign exchange market or as a prudential requirement to prevent excessive exposure, or for both purposes?
- Should the external auditors appointed by shareholders report only to them and to management, or to the supervisory authority as well? Should the approval of the supervisory authority be required for appointing external auditors?
- Should all infractions and penalties be stated specifically in the law? Should some discretionary powers be granted to the supervisory authority in this critical area?
- Under what circumstances should the supervisory authority appoint a conservator? Should shareholders be given an opportunity to replenish the bank's capital before liquidating or selling the bank to third parties? Should the law prohibit the declaration and/or distribution of dividends for banks in distress?
- Should there be categories of privileged creditors or depositors in the liquidation of a bank?

Chapter
9 Bank Failure Case Histories

9A. A Central Bank's Perspective

OLIVER IRELAND

Over the past dozen years, the United States experienced more bank closings than during any other period since the Great Depression of the 1930s. These closings resulted from a variety of causes, including poor loan or investment policies at individual banks; loss of confidence in particular groups of banks; and, more broadly, downturns in regional economies affecting banks in such regions. This latter problem occurred in a number of regions in the United States during the 1980s, including the farm belt, the southwest, and the northeast. Indeed, one might conclude that when the economy suffers, banks suffer.

The purpose of this chapter is not, however, to discuss the causes of bank closings but rather to discuss the central bank's role in these closings, particularly its role as a lender of last resort. In this regard, it is necessary to view central banking functions in the context of the applicable supervisory regime for banking institutions. In the United States, the central bank generally does not charter banks. This point is important because ordinarily in the United States it is the chartering authority that is responsible for closing and, accordingly, determining when to close banks. In addition, the U.S. central bank does not insure or liquidate banks. Thus, it does not have direct control over the manner in which a closed bank is "resolved," that is, whether it is recapitalized or liquidated. Finally, while the U.S. central bank supervises bank holding companies, it supervises only a limited number of banks and, therefore, must rely on information from other supervisors in making certain judgments.

Nevertheless, the central banks' role as lender of last resort is critical in many troubled bank situations. The classic lender-of-last-resort role is to provide liquidity to solvent banks when they are unable to meet their liquidity needs from other sources. One of the primary reasons that a bank may be unable to meet its liquidity needs from other sources is that the bank has lost the confidence of its funding sources—depositors or the financial markets, or both—who are then unwilling to continue to extend credit to the bank. This loss of confidence may or may not result from the actual condition of the bank. If the bank is solvent, lending will serve as

a bridge until the bank can regain market confidence. However, if the bank is insolvent, while the lending may serve certain policy purposes, it may also result in the preferring of those creditors that flee the bank early over other creditors.

A critical element in the formulation of the lender-of-last-resort role is whether the bank needing liquidity assistance is a viable entity. This issue takes on added significance in the United States where the deposit insurance system is ultimately underwritten by the taxpayers. Just as lending to a troubled bank can prefer some creditors over others by allowing the former to withdraw the full amount of their investment while effectively reducing the pool of assets available to the latter in the event of an insolvency, lending can either increase or decrease the costs of resolving a bank to the deposit insurance fund.

The potential for central bank lending to a troubled banking institution to increase the costs of resolving the bank to other-than-favored creditors and to a deposit insurance fund depends on the structure of the central bank lending and on the deposit insurance arrangements. For example, in the United States the deposit insurance fund is obligated to pay insured deposits (up to the statutory maximum) if a bank fails. The fund then steps into the shoes of the depositors that it has paid and has an unsecured claim against the estate of the failed bank. To the extent that the central bank lends to the bank on a fully secured basis before the failure (which the Federal Reserve does), as deposits and other funds flee the bank the central bank replaces unsecured credit with secured credit. The secured credit takes precedence over the claims of the unsecured creditors, including the insurer, and thereby reduces the assets available to meet their claims. This process can result in increasing losses to unsecured creditors and increasing the costs of resolving a troubled bank to the insurer over the costs that would have been incurred if no central bank credit had been provided. Moreover, the specter of this result may encourage creditors to flee troubled institutions ever more quickly.

On the other hand, lending can reduce the costs to the fund, or other creditors, where the central bank lending serves as a bridge to keep a viable bank operating until it can return to market sources of funds or to keep it operating while the insurer arranges for a purchase of the bank in a transaction that is less costly to the insurance fund than if it simply liquidates the bank. Lending in these situations may also have unquantifiable benefits by maintaining confidence in a local, regional, or national banking system, thereby staving off liquidity pressures on other banking institutions.

At this point, it should be noted that the value of assets for which there is not necessarily an active trading market, such as commercial loans, is

directly related to the time available to liquidate the assets. In other words, if liquidity pressures force a bank to liquidate its assets quickly, the bank may have to perform that liquidation at "fire sale" prices, thereby converting a previously solvent bank into an insolvent bank.

Early in this decade, a retrospective analysis of the potential for Federal Reserve lending to increase or decrease costs to the deposit insurance funds in the United States led to legislation designed to reduce the potential costs to the deposit insurer of resolving troubled banks. First, legislation was enacted that requires the insurer to resolve institutions on a least-cost basis.[1] In order to minimize the effect of Federal Reserve lending on the cost of resolution, the legislation also discourages the Federal Reserve from lending to banking institutions that are not viable.[2] The legislation effectively requires the central bank to make up any losses to the deposit insurer for lending beyond certain predetermined time limits designed to allow for prompt resolution decisions.[3] This legislation also included a waiver of the least-cost requirements where there is broad agreement that a least-cost resolution could lead to systemic problems.[4] Subsequent legislation created a preference for deposits over other bank liabilities, thereby potentially improving the recovery of the insurance fund but, at the same time, potentially reducing the recovery of other nondeposit creditors.[5]

With this background, two examples of bank "failures" are now examined:

(i) Continental Illinois National Bank (Continental), where the bank was rescued on a basis that was probably not "least cost," out of concerns for systemic consequences, and (ii) the Ohio thrift crisis, a series of failures that might be characterized as systemic, at least in a particular geographical area.

Continental was a large midwestern bank that had significant exposure to the energy industry. It might have been characterized as a wholesale bank, at least on the funding side, where it relied heavily on money market sources of funds rather than on retail deposits. In the early 1980s, it ran into significant loan quality problems in part due to its dealings with Penn Square, an Oklahoma bank that failed due to energy-related loans. Nevertheless, Continental continued to operate normally until early May of 1984, when a rumor circulated that Continental was going to discuss the insolvency of its holding company with supervisors at the Federal Reserve Bank of Chicago. An official at Continental quickly issued a denial of this rumor. This rumor, and the denial, caused concern among Continental's money market suppliers of funds, particularly foreign suppliers, who either cut off funds or shortened the maturities of their funding and demanded higher rates. The Federal Reserve made up Continental's funding shortfalls with central bank credit that rapidly grew to billions of dollars.

By mid-May, Continental's problems had become pronounced. At that time, the Federal Deposit Insurance Corporation (FDIC) provided Continental with $2 billion in funding in the form of subordinated notes, and the FDIC, the Federal Reserve, and the Office of the Comptroller of the Currency (OCC), the bank's chartering authority, issued a statement that all depositors and other general creditors of the bank would be fully protected. At the same time, a group of major U.S. banks agreed to provide over $5 billion in unsecured credit to the bank. Unfortunately, these steps were not adequate to restore confidence in the bank. Funding continued to erode, and Federal Reserve credit to the bank increased.

In late July of 1984, the FDIC, the Federal Reserve, and the OCC announced a more comprehensive plan to resolve Continental's difficulties. This plan included the infusion of an additional $1 billion in capital, the purchase of $4.5 billion in problem loans from the bank by the FDIC, and the installation of a new management team. The capital was infused through the bank's parent holding company, and the loan purchase was effected in part by the FDIC, which assumed $3.5 billion in loans from the Federal Reserve Bank of Chicago. The announcement of this plan effectively stemmed the erosion of Continental's funding, and its implementation ultimately allowed the bank to remain in business.

Why was Continental "rescued" rather than liquidated? The short answer is because of concerns about systemic risk. Exactly what these concerns were, however, is a matter of some debate. One of Continental's lines of business was correspondent banking for smaller banks. These banks held substantial balances in their accounts at Continental. One fear was that the failure of Continental would trigger the insolvency of these banks because of the losses that they would incur on their deposits with Continental. Another view is that the failure of Continental would have triggered a loss in confidence in the U.S. banking system internationally, thereby making it more difficult for U.S. banks to obtain funding abroad. In any event, the rescue of Continental through open bank assistance saved everyone from learning whether either of these consequences would have come to pass.

The second case is the Ohio thrift crisis. In early 1985, the state of Ohio had about 70 state-chartered savings institutions that were insured by a "private" deposit insurance fund, the Ohio Deposit Guarantee Fund (ODGF). The fund had assets of about $130 million. One of the savings banks insured by ODGF was Home State Savings Bank, an institution based in the city of Cincinnati, with assets of approximately $600–$700 million. Home State was heavily engaged in U.S. government securities transactions with a Florida government securities dealer, E.S.M. Government Securities. E.S.M. was engaged in extensive fraud and failed

abruptly. Press reports that Home State might suffer a large loss due to the failure triggered a run on Home State and it was closed within the week. At that point, it appeared as though the losses at Home State were sufficiently large to trigger the insolvency of the ODGF.

During the next week, public confidence in other ODGF institutions began to deteriorate, and by the end of that week depositor runs forced the state of Ohio to suspend the operations of all of the ODGF-insured institutions. Interestingly, these runs, which appeared to be triggered by loss of confidence in the insurer, did not extend to wholly uninsured thrifts.

Although the run at Home State was largely funded by loans from ODGF, by the time it was closed the Federal Reserve Bank of Cleveland had put in place arrangements to fund further withdrawals if that had proved necessary. During the runs on the remaining ODGF-insured institutions, the Federal Reserve Bank of Cleveland provided loans and shipments of currency to help meet depositor demands. In both cases, the issue of the solvency of these institutions loomed large. While the losses at Home State made it highly likely that Home State was insolvent, the lack of ready access to good supervisory information on the other ODGF institutions made the condition of these institutions far from clear. Ultimately, this lack of information, including lack of information on the quality of collateral that was available to secure Federal Reserve lending, raised serious questions as to the propriety and ability of the Federal Reserve to fund further withdrawals and was a critical factor in determining to close the remaining ODGF-insured institutions.

Subsequent examination of many of the ODGF-insured institutions disclosed that they were viable, and they were able to reopen with federal insurance to help ensure public confidence. Other ODGF-insured institutions were effectively insolvent, and their depositors were made whole only after the state of Ohio elected to protect them.

The Ohio experience is a classic example of the way that failure of a single banking institution leads to runs on other institutions and, in some cases, the failures of those institutions. It also highlights the limitations inherent in the classic lender-of-last-resort function if good supervisory information is not available. In these cases, it simply was not possible to determine whether or not some individual institutions were viable. Thus, in the Ohio situation, uncertainties about the condition of many of the ODGF-insured institutions made it impossible for the Federal Reserve to determine whether prospective lending by it could be supported by adequate collateral and, even if it could be so supported, whether lending to individual institutions would have been solely for liquidity purposes, or whether it would have merely funded the flight of depositors from a fail-

ing institution, thereby effectively creating preferences for those fleeing depositors. Uncertainty as to the availability of Federal Reserve credit led in part to the decision to close the ODGF institutions. Although for the healthy institutions this closing was only temporary, such closing resulted in an interruption in depositors' access to their funds. Interruptions in access to funds can, depending on the circumstances, be almost as serious as a loss of funds. For example, some savings may be for medical purposes. In any event, it is this type of problem that the role of the lender of last resort is designed to avoid.

In sum, in dealing with troubled banks a central bank's powers as lender of last resort can be a two-edged sword, depending on the condition and ultimate resolution of the borrowing institution. In appropriate circumstances, it can serve as a vital source of funds to borrowing institutions, maintaining their operations, protecting their creditors, and thereby guarding against systemic problems. At the same time, used inappropriately these same powers can result in preferring creditors and potentially encouraging their early flight from troubled banking institutions.

9B. Bank Failures in Nordic Countries

MATS A. JOSEFSSON

For some years, the Nordic countries suffered from a severe banking crisis. The problems were most severe in Finland, Norway, and Sweden; Denmark and Iceland also experienced problems, although on a much smaller scale. As a result of the crisis, the authorities in Finland, Norway, and Sweden had to take drastic actions to support problem banks. In all three countries, the governments had to use large amounts of taxpayers' money to rescue insolvent banks in order to safeguard the stability of the banking system and to protect depositors' money. In Norway and Finland also, the central banks were directly involved in providing funding to support ailing banks.

Even though Finland, Norway, and Sweden are neighbors, are closely related to one another, have similar cultures, and have a well-organized system of bank supervisor cooperation, they have chosen different ways to rehabilitate their banking systems. This is a clear signal that bank restructuring strategies should not be duplicated from one country to another. Each country is unique, and what works in one country might not work in another. However, that does not mean that each country has to start from scratch, because there are a number of basic principles regarding what to do and not to do, which are always applicable in any bank restructuring.

Since the crises seem to be over, they can be examined to elicit lessons regarding the complex process of bank rescue operations. The different models used are being thoroughly analyzed—in the IMF and elsewhere—and attempts are being made to assess which model has proved the most successful. Countries still facing banking problems are also closely reviewing the crises to see what they can learn about how to restructure their own banking systems.

The first country to face banking problems was Norway in 1987, while the bank crisis did not hit Finland and Sweden until 1991. One can only wonder to what extent the other countries realized that, if Norway had banking problems, it would only be a question of time until they too were likely to face at least some strains in their own banking systems. Thus, one would have thought that Finland and Sweden would immediately start to consider corrective measures in order to try to avoid a similar crisis or at least to try to minimize the effects of an imminent bank crisis. Unfortunately, they did not. In Sweden, for example, the general belief at that time seems to have been that a bank crisis such as that in Norway would never happen because of Sweden's larger and more diver-

sified economy. Consequently, despite a respite of four years, the authorities did little to prevent or minimize the effects of a developing bank crisis. However, the blame should certainly not rest solely on the authorities. The banks must also bear a large share of the blame because when they noticed the problems that their colleagues were facing in Norway they should have asked themselves if something similar could happen to them.

However, the attitude shown by the authorities—and the banks—is not uncommon. Many countries have shown a lack of recognition of problems at the early stages of their bank crises. Thus, preventive steps are often delayed until a crisis materializes. There should not, however, be any doubt that the earlier the authorities start to act, the less difficult and costly the rehabilitation process will be.

Cause of the Crisis

The causes of the banking problems in the different Nordic countries are similar. In all cases, the crisis was a result of a combination of factors. For example, the Norwegians have recognized that there were three main causes: bad banking, bad luck, and bad policies. Those causes well describe the causes of the crises in Finland and Sweden too.

The first cause was bad banking. Although the supervisory authority has a responsibility to supervise banks, the boards and managements of the banks themselves must ultimately be responsible for what happens in the banks that they are hired to run. They can never blame the supervisory authority or anyone else if problems arise. However, it is human nature to criticize the supervisory authority when problems do arise, but never to compliment it when things go well.

Financial markets in all of the Nordic countries were deregulated during the early and mid-1980s. The deregulation was followed by a period of intense competition for market shares in lending, and the rate of growth in lending became the most important indicator in determining a successful bank. Basic elements in prudent loan assessment were overlooked, credit assessment of new customers was inadequate, proper risk-management systems were not in place, and asset values were overestimated. Furthermore, the euphoria that characterized many financial markets throughout the world in the late 1980s led bank managers to be overly optimistic in establishing branches and subsidiaries both domestically and internationally. Most banking markets became overcrowded, and when the recession started in the early 1990s, there were too many banks and not enough business for all of them. Some banks had to disappear, either by voluntary or forced liquidation or by mergers.

Second, bad luck refers to the international recession that took place in the early 1990s, the length of which surpassed most expectations. In Sweden, the real estate market collapsed, and prices fell by about 50 percent in metropolitan areas in the course of two years. In Norway, the situation was exacerbated by a fall in oil prices and in Finland by the collapse in trade with the Baltic countries, Russia, and other countries of the former Soviet Union.

The third cause, bad policies, refers to the economic policies conducted in the Nordic countries during the latter half of the 1980s. Policies were generally lax, despite a booming economy. The deregulation of financial markets took place during an upturn in the economy, and because interest payments on loans were to a large extent deductible from income taxes, this stimulated an excess demand for credit. At the same time, there was generally a negative attitude toward providing more resources to the supervisory authorities, despite the financial market deregulation. To make matters worse, supervisors were unfamiliar with the new environment and, as in the past, focused more on banks' compliance with laws than on how banks were monitoring and minimizing the risks that they were taking. It became increasingly common to challenge unpopular decisions by supervisors in court; this not only may have caused supervisors to be more reticent to take such decisions, but also may have slowed efforts to introduce stricter supervisory guidelines.

The bank crisis was most severe in Finland. Finnish banks' loan losses in the period of 1989–94 averaged 2.2 percent of gross domestic product.[1] The corresponding figure for Sweden was 2.1 percent and for Norway 1.7 percent.[2] Worth noticing is that the figure for Denmark was 1.5 percent—only slightly lower than Norway's.[3] In Norway, the highest figure of 3.1 percent was recorded in 1991, while Sweden and Finland recorded their highest figures in 1992, 4.9 percent and 4.6 percent, respectively.[4]

Deposit Insurance

In Finland, a compulsory security fund system (deposit insurance) had been in place for some years.[5] Voluntary security funds had also been set up for commercial banks, cooperative banks, and savings banks.[6] The security funds were supposed to repay depositors if this could not be done out of a bank's own resources because of bankruptcy. However, the accumulated resources in all three funds proved to be minimal in relation to potential compensation liabilities.

In Norway, the Savings Banks Guarantee Fund and the Commercial Banks Guarantee Fund had been set up some years prior to the crisis, and

in the initial stage of the crisis banks were supported by these funds. By the beginning of 1991, however, the funds had been drained, and it became clear that they no longer had the financial capacity to constitute a credible safety net for Norwegian banks. By contrast, in Sweden no such funds existed.

Government Support

When the magnitude of the banking problems became clear—as well as the risks posed to the economy as a whole if a number of banks were allowed to fail—the Finnish and the Swedish governments each chose to issue a general guarantee that all banks would meet their obligations. No such guarantee, however, was issued by the Norwegian government.

Finland

In August 1992, the Finnish government issued a statement in which it asserted that the stability of the Finnish banking system would be assured under all circumstances.[7] The commitment was reaffirmed in February 1993, when the Parliament unanimously approved a resolution stating that "Parliament requires the State to guarantee that Finnish banks are able to meet their commitments on time under all circumstances. Whenever necessary, Parliament shall grant sufficient appropriations and powers to be used by the Government for meeting such commitments."[8] According to Finnish sources, this resolution is exceptional in Finnish parliamentary history, because it states that the whole political system stands behind commitments made by Finnish banks.[9]

Sweden

As the banking problems in Sweden worsened, the government became increasingly concerned that confidence in, and the stability of, the Swedish banking system as a whole could be jeopardized if there were a run on Swedish banks. At the same time, the banking problems were exacerbated by the sharp interest rate increases that took place in the wake of the currency crisis in the autumn of 1992, as interest rates were raised up to 500 percent in an unsuccessful attempt to defend the Swedish krona.[10]

In September 1992, after receiving support from the leading opposition party, the Swedish government announced that it would request a broad authorization by the Parliament to take measures to strengthen the payment system and safeguard the supply of credit.[11] The bill, passed in December 1992, stated (i) the state guarantees that banks and certain other credit institutions will meet their obligations on a timely basis,

(ii) the government had been authorized to decide about measures of support, (iii) measures should be based on commercial principles and arranged in a way that would minimize the long-term cost for the state and provide that support paid out could be recovered, (iv) the state would not endeavor to become an owner of banks, (v) all commitments of an institution were covered except its share capital and perpetual debentures, and (vi) the support would be temporary and would be terminated once it could be done without jeopardizing the rights of creditors.[12]

Organization

Special organizations were set up in all three countries to manage the support system for the bank restructuring and to decide on the measures to be taken. In principle, they all operated in a similar way.

In Finland, the Government Guarantee Fund was established in April 1992.[13] The Fund was allowed to provide support to banks in various ways, such as acquisition of bank shares and provision of other types of equity capital, loans, and guarantees.[14] Prior to the establishment of the Government Guarantee Fund, the Bank of Finland had supported one insolvent commercial bank.[15]

In Norway, two separate bank support authorities were set up. First, the Government Bank Insurance Fund was established in March 1991.[16] Its mandate was to provide support loans to the existing banks' guarantee funds to enable them, in turn, to supply risk capital to banks.[17] However, the need for public support grew, leading to the creation of the Government Bank Investment Fund in November 1991.[18] The two funds had different roles to play. State ownership as part of crisis management was the role of the Government Bank Insurance Fund, while state ownership as investor on a commercial basis was the responsibility of the Government Bank Investment Fund.

In Sweden, a decision was taken to set up a Bank Support Authority in December 1992, but the Authority did not begin its work until May 1993.[19] Banks had already started to recover, and most of the restructuring was completed. Prior to the Authority beginning its work in April 1993, bank restructuring had been handled in the Ministry of Finance.[20] An appeal Board for Bank Support Issues was also set up to act as the final instance for assessing support issues in cases where the state and an institution did not reach an agreement.[21]

Forms of Support

In Norway, the main support was provided by the two abovementioned government funds, although the banks' own security funds

were able to provide a substantial amount of support. The Bank of Norway supported problem banks by granting low-interest loans, thereby helping to improve their results. In the course of the restructuring, the three largest Norwegian commercial banks were taken over and recapitalized by the state, and the old share capital was written off.[22] The Norwegian Parliament decided that the state would remain owner of the two largest banks at least until after the election in 1997, while the third bank should be privatized.[23] This implies that the Norwegian authorities, at least for the time being, consider it important that the state has control of the two largest banks.

In Finland, most of the support was given in four different forms. First, when the crisis started the Bank of Finland took control of one insolvent bank, recapitalized it, bought its largest risk exposures, and later sold it to the Government Guarantee Fund.[24] Second, the government offered a general capital infusion to all banks, regardless of their solvency, using a formula based on their risk-weighted assets. The capital was offered in order to secure the support of bank credit to customers. Third, the Government Guarantee Fund bought shares and preferred capital in some banks to safeguard their solvency. Fourth, the state and the Government Guarantee Fund set up and capitalized asset management companies. Large volumes of bad assets in banks being restructured have been transferred to these companies.

In Sweden, all support was provided by the state through a combination of capital injections, guarantees, and loans. More than 98 percent of the total amount paid out was used to capitalize two banks, one of which was already owned by the state.[25] Included in the amount is the capitalization of two new asset management companies set up to recover bad assets in these two banks. These asset management companies have played an important role in handling the Swedish bank crisis.

Public Cost of Bank Restructuring

The Norwegian banks have now recovered, and recent estimates indicate that the Norwegian government will fully recover the support it provided to banks during the crisis.[26] It may even make a profit if all of the government's bank shares are sold.[27]

In Sweden, banks have also recovered substantially. In 1992, the peak year of the crisis, the combined operating losses for the five largest bank groups was SKr 50 billion, while these banks in 1994 had a profit of SKr 12 billion.[28] The government also proposed in a bill to Parliament to abolish the general state guarantee that all banks would meet their obligations as of July 1, 1996.[29] Estimates also indicate that the government

will recover most, if not all, of the support provided through the privatization of the state-owned bank and by successful loan recoveries in the two state-owned asset management companies.[30]

In Finland, however, banks are still facing problems, although the crisis seems to be over. As a group, they were expected to show a loss for 1995 but a small profit in 1996.[31] The Finnish government is not likely to get back all its support. At present, the total cost for restructuring the banking system is estimated to be in the range of Fmk 40 to Fmk 50 billion.[32]

Conclusion

Although the Nordic countries have chosen different ways to solve the problems that they have experienced in their banking systems, there are also many similarities among the methods used. All three countries can be said to have successfully rehabilitated their banking systems in a few years. (In Norway, and probably also in Sweden, the governments are likely to get back all the funds invested in restructuring the banking systems.) The following general conclusions can be drawn from the handling of the Nordic bank crisis:

- Once there are signals about an imminent bank crisis, the authorities need to take action immediately. Early intervention by the authorities is likely to be the most cost-effective way to rehabilitate a banking system.
- There should be a political consensus on how the banking system is to be restructured.
- The government is ultimately responsible for confidence in, and the stability of, the banking system. A deposit protection scheme cannot solve a systemic bank crisis.
- The government should be responsible for the restructuring. This is probably best done by setting up a special government agency to decide on the measures to be taken, to act as owner of any banks taken over, and to administer the support. The supervisory authority or the central bank should not be directly involved in such an agency.
- A step-by-step restructuring should be avoided, because such an approach tends to prolong the crisis; instead, forceful actions should immediately be taken.
- In the Nordic countries, a large part of the support provided was in the form of capital injections. This has proved to be a good way to ensure that a maximum amount of public funds used will be paid

back. To temporarily nationalize insolvent banks and, once they are rehabilitated, reprivatize them, gives the government—not the shareholders—the upside of the restructuring.

- The transfer of bad assets to an asset management company can be a useful way to maximize loan recoveries and to minimize the government's cost. The Nordic experience shows that such a company should be set up outside of the banks.
- No Nordic country allowed a bank to operate unless it met Basle capital standards.[33]
- No depositors have lost any money in the Nordic bank crisis. This clearly indicates how unwilling the governments were to let banks fail. However, shareholders have lost a substantial amount of money in all three countries.

9C. Bank Failures in Latin America

ERNESTO V. FELDMAN

Introduction

Bank failures, as isolated episodes or as part of more widespread processes leading to banking crises,[1] have become a worldwide phenomenon in recent years. Bank failures have been a feature of the recent economic scene in industrial countries (for example, Japan and the Nordic countries) and in developing countries.

While in the case of industrial countries bank failures and crises have been costly, the damage that they caused seems to have been far greater for developing countries (including economies in transition). This has been particularly true for Latin American countries. Open systemic banking crises have occurred in the past several years in Argentina, Bolivia, Mexico, Paraguay, and Venezuela, while important cases of bank failures—without reaching systemic proportions—affected several other countries, notably Costa Rica, Ecuador, and Brazil. In contrast, countries like Chile, Colombia, and Uruguay remained unaffected even after the emergence of the Mexican crisis in December 1994.

As for the developing countries and, in particular, Latin American countries, the IMF has become increasingly aware of the threats that bank failures pose on macroeconomic stability. In turn, macroeconomic instability has been seen as one of the main factors explaining banking crises. The fragility of the banking sector in a number of Latin American countries has highlighted the serious problems that could arise for stabilization efforts or growth if insolvency undermines the soundness of the banking system. The answer to bank failures is to strengthen the efforts to identify and address problem banks, and to strengthen prudential regulation and banking supervision.

Causes of Bank Failures and Deposit Runs, and Responses from the Authorities

While recent interest in bank failures has been mostly concentrated on the Mexican crisis and its spillover effects, many lessons can be drawn from the earlier Venezuelan banking crisis that emerged in January 1994, when Banco Latino was closed and after a few days reopened under state management.

In general, the nature and causes of banking failures and crises differ among Latin American countries. However, there are some common factors that are important to underscore, such as uncertainty regarding the future direction of macroeconomic policies (particularly when the country is experiencing serious imbalances that affect, among other things, the normal functioning of its banking sector) and bank mismanagement (including irregularities and fraud that unfold in the framework of perceived weakness of prudential regulations and banking supervision). These two causes could be considered of an *endogenous* nature, mostly generated within the banking sector itself or resulting from the interaction between the real and the banking sectors. Another set of causes relates to unexpected *exogenous* shocks, such as an abrupt deterioration in the country's terms of trade or developments taking place in other parts of the world. There are also other kinds of shocks that can be domestically generated, like an unexpected election result, the worsening of a leading economic indicator, or the decline in the net worth of a particular class of bank borrowers affected by a change in relative prices. These are domestic shocks, but still of an exogenous nature in the sense that they do not originate in any factor inherent to the functioning of the banking system.

A major feature of most episodes of bank failures is deposit runs; still, not all bank failures entail generalized deposit runs. Analysis of bank failures in Argentina, Mexico, and Venezuela provides examples of different depositors' behavior and the nature of deposit runs.

The Venezuelan and Mexican banking crises can both be broadly characterized as being triggered by endogenous factors. Inconsistent macroeconomic policies, combined (particularly in the Venezuelan case) with poor bank management; significant corruption and fraud; and lack of appropriate banking supervision led to a strong deterioration in the depositors' perception of the viability of banks. While both the Venezuelan and the Mexican crises share a number of features, there were fundamental differences in depositors' reactions in the two countries. In particular, Venezuela suffered significant deposit runs, while Mexico did not. In both countries, there existed the deeply rooted belief, based upon past historic experiences, that the state would eventually come to the rescue of ailing banks. Policies implicitly supported the confidence of depositors who expected to be protected, irrespective of the depth of the crisis.[2]

Even more interesting is a comparison between the Venezuelan and Argentine banking crises because both involve significant deposit runs. However, they differ in a substantive way in two respects, namely, the factors that triggered the run and the scope of the run. In the Venezuelan case, deposit runs started once the interbank market and the central bank took the decision to halt the financial support to Banco Latino, the sec-

ond largest private bank. Shortly thereafter, a group of banks perceived by depositors as financially weak and risky started suffering deposit runs. The Venezuelan crisis is characterized by the fact that deposit runs were "targeted" at a group of banks that the market believed to be in poor financial condition. A process of deposit redistribution then took place from "ailing" to "healthy" banks so that runs were not generalized.[3]

In contrast, the Argentine banking crisis was clearly triggered by an external shock (the Mexican crisis) and affected all banks (even though with different intensity). Despite some financial problems that had started to unfold before the emergence of the Mexican crisis of December 1994, the Argentine banking sector was basically sound; it showed a reasonable level of solvency and liquidity. The sudden change in expectations about the underlying fundamentals of the Argentine banking system, caused by the Mexican crisis, led to a generalized deposit run that affected all banks and bank categories.[4]

The difference between deposit runs in Venezuela and Argentina is remarkable. In Venezuela, practically all banks were privately owned, and the crisis was endogenously generated when the market decided that the long-standing problems of some banks (compounded by significant macroeconomic imbalances) were no longer sustainable. In contrast, the Argentine banking system was affected by depositors' fear about the fate of the entire banking system after the emergence of the Mexican crisis. In addition, the disturbing history of policies adopted by the government to resolve previous financial crises also generated negative expectations.

The immediate response of financial authorities to deposit runs and bank failures also differed importantly among Latin American countries. A distinction can be made between cosmetic solutions and the adoption of measures of a more permanent nature aimed at consolidating the condition of the banking system.

Nonsystemic Bank Failures

Costa Rica and Brazil provide cases where failures of large banks have not resulted in systemic banking crises. In Costa Rica, Banco Anglo Costarricense, a large state bank, was closed in December 1994 after incurring losses representing 2 percentage points of GDP. Some important economic events during 1995 dispelled the threat of a systemic crisis, although many problems still persist in the banking system.

In Brazil, the successful adoption of Plan Real in June 1994 brought about deep changes in the functioning of the banking system. Banks lost the profits that had resulted from the "float" in the context of high inflation, and many of them could not adapt to the new situation of low infla-

tion. Many small banks and two large private banks failed during 1995, but the situation cannot be characterized as one of systemic crisis. Nevertheless, the authorities need to address some serious problems affecting the banking sector that, if unattended, could ultimately jeopardize the success achieved on the macroeconomic front.

Conclusion

Several lessons can be drawn from the recent bank failures and crises that have occurred in Latin America. In particular, the authorities need to introduce and maintain comprehensive strategies to address problem banks. In addition, they need to strengthen prudential regulation and banking supervision in order to protect the soundness of their banking systems and, indirectly, their countries' macroeconomic stance.

COMMENT

CARL-JOHAN LINDGREN

The preceding chapters present different case histories of bank failures. Together they bring out key issues for dealing with bank failures. This comment focuses on these issues and their legal implications. The IMF has done a lot of work on problem banks in recent years, and from this work it is evident that this is an area in which good banking legislation is needed the most but in reality often is the weakest.

A distinction needs to be made between individual bank problems and systemic ones. The policy response and the legal framework necessary for dealing with the two types of problems are quite different. Most countries have legislation to deal with individual bank failures, but not with systemic ones. The experience in the three Nordic countries shows that in cases of truly systemic crisis that affect most of or the entire banking system, there is a need for special legislation, which may include blanket guarantees and the formation of bank restructuring, loan recovery, or asset management agencies. Furthermore, there also is a need to define the distribution of responsibilities between such new agencies and existing ones.

What constitutes a systemic problem? When a bank is failing, especially if it is a large bank, the authorities often claim that the bank is "too big to fail" or that a failure would have "systemic" consequences. This may be true, but it is also too often an excuse for not applying the law regarding how to deal with individual banks because most banking laws leave the door open for discretionary actions in cases of systemic problems, typically without defining what constitutes such problems. Systemic problems are those problems that spread to other sound banks, affect the payments system, impair the credit channel, and have severe effects on the real economy. The case of Continental Illinois in the United States, with a market share of less than 2 percent, was not a systemic problem. (Subsequent studies have indicated that only two very small banks would have failed had the bank been closed and liquidated. In this case, however, official policy seems to have been driven more by concerns about the effects that a failure of a major U.S. money center bank would have had on foreign depositors.) Even when a bank with a much larger share of the market fails, there need be no systemic effects. In 1995, four private banks in Paraguay (with a market share of about 13 percent) failed without systemic effects. Typically, other banks know when a bank is in trouble and reduce their exposure. For example, when

the Bank for Credit and Commerce International failed there were no systemic repercussions.[1]

When dealing with individual problem banks, the legal framework should provide for a range of gradually more severe enforcement actions, leading up to conservatorship, closure, and liquidation. Experience shows that when a bank is in difficulty and about to fail, the earlier the intervention, the less risk there is that the failure will contaminate the rest of the system. Also, the earlier the intervention takes place—when the negative net worth still is small—the more likely it is that no one, with the exception of the shareholders, will incur major losses. This calls for strict exit rules, which also will ensure that the banking system remains sound. It should be noted that governments and politicians often are reluctant to apply strict exit rules to banks. The United States is the first country to introduce a range of early corrective actions and mandatory official intervention in case of critically undercapitalized banks.[2]

The roles of a lender of last resort—normally (but not always) carried out by the central bank—and that of a deposit insurance scheme are important when dealing with bank failures. The cases in Ohio[3] and Argentina,[4] described in the previous chapters, are interesting because they show that where there were no lender-of-last-resort facilities and no credible deposit insurance scheme, solvent banks easily became exposed. In Argentina, the lender-of-last-resort facilities had been outlawed under the currency board regime (the Convertibility Law),[5] and deposit insurance had been eliminated in favor of a preference for small depositors in liquidation. Both cases show the benefits of properly designed lender-of-last-resort facilities and deposit insurance scheme facilities.

Management of a lender-of-last-resort facility is difficult. The standard rule is that the lender of last resort should provide liquidity to solvent and viable banks against collateral and at a penalty rate. In order to do so, the lender of last resort needs to be guided by information from the supervisory authority as to which banks are insolvent; at the same time, it should be noted that data on banks' solvency often are notoriously misleading. Market forces discipline weak banks by limiting their funding sources, typically by reducing their access to the interbank market. If the lender of last resort lends to insolvent banks, it prolongs their life and, in most cases, allows their losses to grow. Even if the lender of last resort lends to an insolvent bank against collateral, it may only force larger losses on unsecured creditors and thus becomes partly responsible for those losses. It is interesting to note that in the United States there are now statutory provisions that make the central bank liable to the Federal Deposit Insurance Corporation (FDIC) for the loss that the latter incurs in consequence of the advances made by the central bank to a critically under-

capitalized bank that forestalled the earlier liquidation of that bank by the FDIC.[6]

Consequently, the lender of last resort often faces a dilemma, especially in situations where a large part of the system is fragile, that is, where several or all banks are financially weak. If it decides not to support one insolvent bank, it signals that it will not support other weak banks, and this may trigger a systemic crisis. If it continues to provide liquidity, it facilitates a further deterioration of the system. What is needed in such a situation is a comprehensive restructuring strategy in order to avoid the failure of other banks and a gradual erosion of confidence. To the extent such a strategy requires lender-of-last-resort credit, which would be financing equity rather than liquidity, the credit should be explicitly guaranteed by the government. The real dilemma, of course, would be if the government refuses to cooperate.

Deposit insurance is an important instrument for depositor confidence. However, experience seems to suggest that, in a systemic crisis, a limited deposit insurance scheme will not be adequate—only a full coverage of all bank liabilities will guarantee confidence in the system. At the same time, it is not advisable to provide full coverage in normal times because this would give rise to excessive moral hazard. It would eliminate the incentive for market forces (interbank and other large depositors and creditors) to exercise discipline. The conclusion is that depositor protection should be limited to consumer protection of small savers and that blanket guarantees should be used only on a temporary basis in cases of systemic crisis.

In dealing with bank failures and resolution issues, one of the greatest challenges appears to be how to balance the use of rules versus discretion. Experience has shown that discretion often does not result in efficient policies. In many countries, there now seems to be a trend toward better definition of the rules before problems occur. The following questions should be considered when the establishment or amendment of such rules is under consideration:

- Is there a need for strict exit rules when banks are nearing or reaching insolvency?
- Should different rules apply in the case of systemic problems?
- Should systemic problems be defined in the law?
- Should one legislate for systemic problems—or do they occur so seldom that there is no need for standing legislation?
- Are strict rules for the lender of last resort useful, and how feasible is it to adhere to such rules?

- How can legislation help involve the government in the case of systemic problems if it is reluctant to recognize them?
- Should legal provisions require the government to provide explicit guarantees whenever the lender of last resort (typically the central bank) considers it necessary, or whenever that lender is instructed by the government, to lend to banks that it believes to be insolvent?

Afterword to Chapters 8 and 9

MANUEL GUITIÁN

Three subjects raised in Chapters 8 and 9 deserve further elaboration. First, what degree of independence should the supervisory authority have? Or, in other words, what should be the relationship between the supervisory authority and the political authority? To be effective, supervision has to be independent from political considerations for reasons similar to those that justify similar independence in monetary policy. As is well known, there is a growing consensus that the monetary authority should be independent from day-to-day political interference. An analogous, even stronger case may be made with respect to supervision, where a number of very complex issues must be addressed, and delicate judgments must be made.

Independence can be described as the ability of the supervisory authority to exercise its responsibility without political interference concerning the judgments that have to be made in the discharge of the supervision function. Needless to say, there are difficult questions to be sorted out when dealing with banks in distress. When the scope of the problem is contained—that is, limited to a few individual bank cases—there is normally little actual disagreement with the notion of independence. This is only natural because, when the magnitude of the problem at hand is small, the mileage to be gained by interference is also likely to be limited; so, why bother? But the situation changes when banking difficulties exhibit the prospect of systemic repercussions, the subject to which I now turn.

What should be the role of the government when systemic threats arise is the second topic that warrants attention. When such threats are perceived, the typical reaction of governments is to come to the protection or to the rescue of the system at large. As indicated in the introduction to Chapters 8 and 9, it is very important to allocate responsibilities properly—that is, to distribute the burden of the safeguard or the rescue equitably. Since this task typically involves public funds, it is only natural for the government to have a view on the matter. In this context, it must be pointed out that, in principle, the supervisory function—which seeks to identify those banks that are vulnerable, to determine their financial position, and to decide which banks are insolvent—needs to be distinguished from the political judgment concerning the need to rescue the banking sector—which can only be made by the government.

In practice, however, it can prove difficult to keep clear-cut, well-defined boundaries between the various functions or to reach consensus

on the distribution of responsibilities among official entities. For example, as you know, views differ on whether central banks should be vested with the responsibility for bank supervision in addition to their monetary policy duties. Even where this is not the case, the fact of the matter is that to fulfill the latter duties properly, central banks do have to supervise banks.

As far as bank restructuring is concerned, however, whether or not they carry formal responsibility for supervision, it is critical to ensure that central banks do not provide the financing for such restructuring. Indeed, if by keeping supervision out of the central bank it could be assured that there would be no central bank financing for banking difficulties, this would be a strong argument for separation. But, of course, a similar outcome can be attained by keeping the supervisory authority within the central bank and making clear that no central bank resources will be made available for bank rescues.

How transparent should be the rules governing bank failures is the third subject of interest. Obviously, for individual bank problems the rules should be quite transparent. Legislation and norms on how to handle individual bank failures exist in most countries. However, when it comes to dealing with systemic threats and the exercise of the lender-of-last-resort function, arguments have been made that a measure of "constructive" ambiguity would be desirable, if not necessary. Inevitably, though, there are costs to the pursuit of such ambiguity. No matter the degree of ambiguity that may prevail ex ante, markets are likely to be aware that the central bank will support the banking system when it enters into difficulties by providing liquidity, so that discipline will be lost, and systemic threats may increase in scale and probability. The classic (and transparent) statement of the proper discharge of the lender-of-last-resort responsibility has been made by Walter Bagehot in *Lombard Street* (1873).[1] He argued that central banks should provide support to banks that are illiquid; they should provide support without limit; and they should provide it at a penalty rate. According to him, as long as these principles are well known, confidence will be there because the system will know that the central bank would come in only to support illiquid—not insolvent—banks, and on which terms.

But the gist of the problem lies in the distinction of illiquid banks from insolvent banks. This is another instance of a concept that in theory is clear, yet in practice becomes complicated to pinpoint. In my own mind, rules should be as transparent as possible. From an economic point of view, systemic threats, if allowed to materialize, are likely to have a sizable cost for the economy at large. This is indeed the key reason why governments seek to prevent banking sectors from collapsing; such collapses would bring about severe disruptions in the real economy, with large con-

sequent costs in terms of welfare. In effect, the protection of banking sector soundness is a public good, a public service; and like any other public service, it carries a cost. Therefore, an argument can be made that the use of taxes to protect the stability of the financial sector is proper and due. But what are the precise, unambiguous criteria by which a systemic problem is defined? Here again, there is no categorical answer. This is unfortunate, because there is a typical criticism that will always haunt governments when they act to protect the system from a threat of collapse. When they do it well and the system is kept safe, it is always possible to argue that the problem was not systemic. And yet, had the authorities not intervened, a systemic collapse could have occurred.

Another consideration is that, when in doubt, there is a tendency for governments to act before letting the systemic threat go too far—to err on the side of "well, since it looks systemic, we have to go in." This tendency can turn out to be costly because at times authorities will have intervened when the threat was not really systemic. Yet, this is virtually inevitable because intervening late is equivalent to accepting the collapse. The difficult issue is to decide to what extent to allow market forces and discipline to be the final arbiters of the seriousness of the threat. The rationale of the New Zealand approach, examined in Chapter 8, is basically to "let the market supervise." The logical conclusion of this approach would be that market discipline will be left to resolve any systemic problem that arises. Ignored by such an approach would be the market failures, the externalities, and similar arguments that can justify government intervention. The issue at stake here, of course, is one of defining the respective roles to be played by governments on the one hand and by market forces on the other. Needless to say, this has been one of the perennial questions in economics; to demonstrate it, let me quote John Stuart Mill, who, a century and a half ago, wrote: "One of the most disputed questions both in political science and in practical statesmanship at this particular period relates to the proper limits of the functions and agency of governments."[2]

Foreword to Chapters 10 and 11

WILLIAM BLAIR[1]

Introduction

Chapters 10 and 11 deal with banks in distress. For bank supervisors, this presents the ultimate challenge. Much regulatory law relating to solvency and the conduct of business is intended to prevent this situation from occurring. However, since the time that banking emerged as a distinct business, banks have collapsed or teetered on the edge of collapse, and no amount of good regulation will prevent this from happening in the future. Barings Bank, which recently failed, had already faced collapse in the 1890s (and had to be rescued by the Bank of England then). History tends to repeat itself.

Marked changes have occurred in international banking over the past decade. The structure of banks and the activities that they carry out have diversified, to some extent outrunning traditional regulatory techniques. Many banks are now contained within financial conglomerates, with the attendant risk of intragroup contagion. Banking business has expanded and blurred into securities, investment, and insurance-related businesses, even in countries such as the United States and Japan that have not historically recognized the concept of universal banking as it exists in some countries of the European Union. The emergence of secondary debt-trading markets, asset securitization, and credit derivatives have all provided increasing liquidity to bank balance sheets. It is hardly possible to underestimate the importance of the growth of derivatives. International banks have assumed a role in both the exchange-traded and over-the-counter (OTC) derivatives markets. They possess enormous swaps and derivatives trading portfolios and have increasingly relied on proprietary trading to supplement profits, as spreads from traditional banking activities have narrowed. Finally, advances in technology have linked financial markets on an international basis and, at the same time, facilitated an explosion in product innovation, the performance of which is sometimes untried.

As the nature of the business of banking changes, so do the risks. This introduction has three sections. First, consideration is given to the different causes of bank distress. Second, some regulatory issues are introduced. Third, the steps available to resolve specific cases, which frequently call into play national insolvency laws, are addressed.

Causes of Bank Distress

In approaching the topic of the causes of bank distress, it is important to keep in mind that the causes—and the effect—of bank distress differ widely. Viewed internationally, the causes are usually macroeconomic. There are three prominent, recent examples. The Mexican bank crisis was sparked by the 1994 peso crisis.[2] The problems in Japan's financial sector stem from the collapse of the equity and property markets. In addition, the problems in Russia's banks are exacerbated by continuing difficulties in implementing the government's stabilization program.

These are fundamental economic issues beyond the remit of the supervisor. Distress is not limited to particular banks, but felt across the entire sector. A worrying aspect of the Mexican crisis was the potential for a ripple effect in other emerging markets in Latin America and elsewhere, as investor confidence was affected. The crisis led to the enormous international support package that was put together in 1995.

In one sense, the headline cases over the past few years—Barings and Daiwa—were not typical because their problems were directly linked to incompetence and fraud within the individual institutions. In such cases, sound supervision can make a vital difference. The attention of the supervisors has recently been focused on banks' derivatives activities. A combination of factors—primarily the size of potential exposures and the risk of contagion—has led to a major international effort to refine regulatory and banking techniques. Both regulators and, indeed, the banks themselves are (or should be) deeply concerned about the need to prevent derivatives activity from spiraling out of control and thereby threatening their own institutions.

To put the issues into perspective, the following is a summary of some of the potential causes (or symptoms) of bank distress, together with several contemporary examples.

Bad Loans

Banking in its traditional form is the onlending of deposits at a profit. Bad loans (or bad debt) are the classic cause of bank failure. Sometimes bad loans mount simply as a result of the incompetence of the institution concerned through a failure to make appropriate credit judgments. Sometimes, the causes are macroeconomic; for example, in the case of a severe economic downturn. Often, a combination of factors is involved. In Mexico, the effect of the peso crisis was to force interest rates sharply higher and to more than triple the amount of Mexican banks' loans. Some institutions found that a third of their loans had turned bad. By

contrast, typical banks in developed countries might find that 4 percent to 5 percent of their loans go bad. However, fraud and irregularity also seem to have played their part. In May 1994, the Mexican government took over Grupo Havre after regulators detected fraud. Furthermore, in December 1994, investigators discovered irregularities in the accounts of the financial services group Banpais-Asimex, causing the government, in March 1995, to take over the management of both the flagship bank Banpais and the group's insurance firm Asimex.

Market Risk Through Proprietary Trading Losses

The potential for exposure in this regard has been enhanced by the development of OTC derivatives markets and through the increased use of leverage in respect of such instruments.

Difficulty in Realizing Collateral

An elementary principle of good banking is that loans should be made on the basis of the creditworthiness of the borrower, not on the strength of collateral. Nevertheless, when loans go bad banks need to be able to realize their collateral. A collapsed market in widely held collateral may exacerbate bad loan difficulties. In Japan, the collapse in the real estate market has not only produced bad loans, but has also undermined the value of real estate held as collateral. A specific aspect of Japan's real property problems and their effect on the financial sector that has attracted international attention relates to the housing loan companies, or *jusen*, set up in the 1970s to offer mortgages to Japanese consumers. The funding for these non-deposit-taking institutions was provided through Japanese banks and credit unions, which are now owed enormous sums of money by the insolvent *jusen*. In April 1996, Japan's House of Representatives passed a fiscal budget bill featuring the disbursement of taxpayer funds for liquidating all seven *jusen*, but the process remains highly controversial politically.[3] The *jusen* affair has been compared to the savings and loan problem in the United States, both in terms of size and in the serious underlying economic and financial implications.

Since trading losses mount quickly from leveraged OTC derivatives activities, the maintenance of effective collateral is particularly important. Several recent private sector initiatives have been undertaken to minimize risk and maximize efficiency in the documentation of collateral in derivatives transactions, including plans sponsored by the Chicago Mercantile Exchange to establish the world's first OTC swaps collateral depository.[4]

Apart from market problems, the value of collateral can be compromised by ineffective laws governing bankruptcy and realization. In the post-Soviet

economies of Eastern Europe and elsewhere, a major focus of legal reform has been the enactment of new or revised laws governing these matters.[5]

Fraud and Gross Negligence

Fraud has to be particularly serious to plunge a bank into insolvency. Perhaps the most striking recent example involved Bank of Credit and Commerce International (BCCI),[6] but there are other examples as well. Allegations of fraud on the part of senior executives of Banco Español de Credito (Banesto) have been the subject of judicial inquiry in Spain. Such fraud need not necessarily take place within banks to have grave effects on banks. For example, in Japan two credit unions were merged into Tokyo Kyoto Bank in order to facilitate a workout. The bank later filed criminal and civil complaints against the management of its two predecessor credit unions for fraud. It was alleged that huge amounts of money had been squandered on a poorly planned golf course and real estate projects.

Prompted by the savings and loans crisis, the U.S. Congress, in order to enhance the powers of its agencies and instrumentalities to pursue bank insiders and recover assets on behalf of these institutions, enacted certain provisions under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to facilitate such redress.[7] These provisions[8] have been used extensively and successfully by banking regulators in the United States against corrupt or grossly negligent bank insiders, and current debate exists as to whether a standard of culpability less than gross negligence may be sufficient in certain cases to prevail against directors and officers.[9]

Mismanagement and Lack of Internal Controls

The immediate cause of the Barings collapse was proprietary trading in exchange-traded derivative contracts on the Singapore International Monetary Exchange and various Japanese futures exchanges by an unsupervised trader in an offshore subsidiary of the bank called Barings Futures (Singapore) Pte Ltd. Although the "rogue trader" managed to accumulate large unrealized trading losses over several years of trading through control over the front office (trading) and back office (settlement) functions and the use of fictitious client accounts, this alone would not have resulted in the collapse of the parent, Barings plc, if management and auditors had moved to halt these activities in time. In fact, the trader accumulated the majority of the losses (which totaled about £827 million) in less than two months (over January and February 1995) through stacked and unhedged leverage positions in exchange-traded futures and options. These positions required margin payments to the

exchanges that the parent bank continued to make until less than one week prior to its being placed in administration. The subsequent reports issued by the U.K. Board of Banking Supervision[10] and auditors engaged by the Singapore Ministry of Finance[11] made it clear that the Barings plc collapse was caused principally by incompetence, lack of internal controls, and (according to the Singapore report) a coverup to protect the large profits purportedly made by this trader from what were supposedly low-risk interexchange arbitrage activities. Proper controls would have detected the true position much earlier and saved the bank.

Regulatory Closure

Another recent case involved the closure of the Daiwa Bank's operations in the United States by federal and state banking authorities; the ensuing criminal and civil prosecution of the bank and several of its officers for deliberately concealing and failing to report an accumulated total of nearly $1.1 billion in U.S. treasury securities trading losses over 11 years; and the consequent measures taken by the Japanese Ministry of Finance.[12] The focus of the Daiwa problem, similar to that of Barings, was the bank's failure to establish and maintain appropriate controls over the New York branch's securities trading and custodial services, both of which were controlled by the same person. The bank initially pleaded its innocence to the criminal and civil charges filed against it.[13] In February 1996, however, it pleaded guilty to 16 felony counts and agreed to pay a $340 million fine.[14]

Some Regulatory Issues

Proper disclosure of information is central to the regulatory process—although in itself disclosure is not a panacea. The information must be assessed and judgments (often difficult judgments) made as to the appropriate response. However, three particular areas are of concern. In each of these areas, considerable attention has recently been paid to risks posed to banks and other financial institutions by derivatives.

The Importance of Internal Controls

Ever since banking evolved from one man and a ledger, sound internal controls have been of the essence of good practice. The large exposures that proprietary trading in derivatives can generate have served to emphasize this point. In the United States, reports issued by the Commodity Futures Trading Commission (CFTC)[15] and the General Accounting Office[16] both emphasized the importance of internal controls as the first

line of defense against the risks posed by OTC derivatives transactions.[17] The failure of Barings constitutes a textbook case in this respect. In its report into the collapse of Barings, the U.K. Board of Banking Supervision emphasized five significant lessons for the management and directors of all financial institutions:

(a) Management teams have a duty to understand fully the businesses they manage;

(b) Responsibility for each business activity has to be clearly established and communicated;

(c) Clear segregation of duties is fundamental to any effective control system;

(d) Relevant internal controls, including independent risk management, have to be established for all business activities;

(e) Top management and the Audit Committee have to ensure that significant weaknesses, identified to them by internal audit or otherwise, are resolved quickly;[18]

Of these five lessons, perhaps the clearest lesson to emerge from the Barings collapse is that institutions must recognize the dangers of not separating responsibility for "front office" (that is, the trading) and "back office" (that is, the record-keeping) functions.

The events at Barings alarmed bankers around the world. The moral is that, in complex international markets where enormous losses can be suffered quickly, it is fatal to permit traders—whether or not rogue traders—to operate without firm control. The difficulties can be exacerbated where the trading activity takes place in a foreign branch subject to only periodic visitations by the head office.

Risk Management

Chapters 10A and 10B address internal controls and risk management for banks. Internal controls and risk management are interlinked concepts. These matters were raised in the investigation of the Barings collapse.[19] In the derivatives context, dealer banks and end-user banks must establish risk-management guidelines and policies commensurate with the amount of derivatives activities and risk involved. The U.S. Securities and Exchange Commission (SEC) requires risk-management policies for securities firms in respect of OTC derivatives to include the establishment of independent risk-management functions, such as credit and internal audit committees, separate from the trading functions of the firm.[20] Emphasis has been placed on the roles of directors and officers in this process and the expectation that the boards of directors should promulgate clearly articulated policies concerning derivatives and continuously

update those policies as business and market climates change. These matters are the subject of understandings between the U.S. SEC, the U.S. CFTC, and the U.K. Securities and Investments Board (SIB).[21] In addition, risk management has become a principal focus of the U.S. banking regulators. The Board of Governors of the Federal Reserve System, the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) have each initiated broad regulatory reforms with respect to the risk management of banks' trading activities.[22] For example, the OCC has issued guidelines on managing the risks of derivatives by national banks for their fiduciary accounts.[23] These guidelines will supplement the OCC's influential new "supervision by risk" program of national bank activities introduced in early 1996.[24] In the case of the Federal Reserve, the agency plans to conduct risk examinations that will result in a specific grade attached to the institution's risk-management performance; these examinations will focus not only on the risk models used by an institution, but also on its risk-management process, including the institution's internal controls. Several industry groups in the United Kingdom have also promulgated guidelines to address principles for the effective management of derivatives risks.[25]

Sharing of Information Between Supervisory Authorities

Sharing of information between supervisory authorities is the subject of Chapter 11. The world's financial sector is inextricably interlinked. This interconnection is only increased with the emergence of universal banking carried out by financial conglomerates, even in countries such as the United States and Japan, which for many years separated banking and securities businesses. However, regulatory structures often do not reflect the underlying unity of the financial sector. Again, the Barings collapse provides important insights, which are summarized by the following commentary:

> The problem arose because a Barings group company, supervised by a securities/derivatives regulator, was trading in derivatives on exchanges located in two countries [that is, Japan and Singapore]. These exchanges were each supervised by a different self-regulatory organisation, which in turn reported to different futures regulators. Finally, the company was funded by a related banking entity in the UK, supervised by both banking and securities regulators, via another related securities firm, supervised by a securities regulator.
>
> Barings clearly raises the question of gaps in international regulatory co-ordination, not just between different securities regulators, but also between securities and banking regulators. The question that Barings really raises is how to treat multinational hybrid securities/banking financial conglomerates. This is a matter that is becoming all the more important with financial deregulation, such as the impending repeal of the Glass-Steagall Act in the USA.

> The issue is how to reconcile the differing treatment of bank and securities regulators in taking into account, or ignoring, the financial effect of the activities of a foreign subsidiary on a domestic parent firm. In particular, Barings raised this issue in the context of the allocation of responsibilities between home and host country regulators. It is this crucial issue that will have to be addressed in the light of the demise of Barings.[26]

In the wake of Barings, there have been a number of efforts internationally to address these issues. Specifically, there is the influential "Windsor Declaration"[27] issued after a conference on the supervision of futures exchanges in May 1995, hosted by the U.S. CFTC and the U.K. SIB.[28] Among other matters, the regulators agreed to support mechanisms to improve the prompt communication of information relevant to material exposures and other regulatory concerns. The Windsor Declaration was endorsed by all 72 members of the International Organization of Securities Commissions (IOSCO) in July 1995.[29] Mention should also be made of the joint report of the Basle Committee and IOSCO entitled *Public Disclosure of the Trading and Derivatives Activities of Banks and Securities Firms* (November 1995). In March 1996, futures regulators from 14 jurisdictions signed an information-sharing accord to foster better supervision of the world's futures markets.[30] The Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations provides a multilateral mechanism to share information on a bilateral basis, consistent with the respective parties' legal and contractual obligations.[31] The regulators' declaration complements the memorandum of understanding signed by 62 international futures exchanges and clearing organizations.[32]

International Joint Supervisory Initiatives

The Basle Committee on Banking Supervision and IOSCO have undertaken several joint projects with a view to: (i) the establishment of a common framework of principles for regulation and supervision of the derivatives activities of banks and securities firms, (ii) the supervision of international financial conglomerates, and (iii) the disclosure of trading activities of banks and securities firms. The intention is to promote better international standards of transparency and disclosure.

Summary of Recent Regulatory Moves

To summarize these regulatory moves, the aims have been basically threefold. The first aim is to strengthen individual banks so that they can withstand shocks. The traditional approach, reflected in capital adequacy requirements based on the Basle Accord, has had to be modified in light of off-balance-sheet derivatives.[33] A significant development of this mod-

ification is a new approach to market risk, subject to strict qualitative and quantitative standards. International banks are now permitted to choose between using the standardized method contained in the adopted principles or their own in-house value-at-risk models to calculate their particular market risks.[34]

The second aim is to strengthen risk management within banks. The Institute of International Finance has expressed the rationale that banks publicly disclosing their internal estimates of market risks will foster market discipline and ensure that firms know their conterparties.[35] Legally, strengthening risk management ranges from reviewing standard form documentation to vetting particular counterparties (for example, in respect of the adequacy of collateral, whether the counterparty has proper authority, and other issues).

The third aim is to strengthen the financial infrastructure to prevent individual shocks from spreading. Netting is a key to this, because the credit exposure of a bank trading in derivatives is mitigated if netting with counterparties is firmly in place. Of the Lamfalussy Report minimum standards[36] to be met to ensure an effective system of netting, one is particularly noteworthy: "Netting schemes should have a well-founded legal basis under all relevant jurisdictions."[37] Two initiatives should be mentioned. In April 1995, the Basle Committee on Banking Supervision issued a report addressing the question of bilateral netting in the context of off-balance-sheet items, such as OTC derivatives.[38] In addition, in April 1996 it issued a report dealing with multilateral netting arrangements on the forward foreign exchange markets.[39]

Resolving Distress

If a bank gets into distress, how should the matter be addressed? There are a number of rescue techniques, some of which require public funding, and others that do not. These include bailout, nationalization, reconstruction, recapitalization, sale, takeover, and merger. Sometimes a "resolution trust corporation" is set up to recover bad debt on behalf of the rescuing authority. Whatever method used, there are likely to be implications for the national deposit insurance scheme, if there is one. In the United States, the FDIC can acquire a problem bank and operate it as a "bridge bank" for two years.[40] Experience in particular countries will show which forms of rescue are best suited to local circumstances.

Central bank laws often contain provisions enabling the central bank to use bankruptcy procedures in respect of commercial banks. There are two basic forms of bankruptcy procedure. One is intended to preserve the institution as a going concern and facilitate its eventual rehabilitation.[41]

The other is intended to achieve the liquidation of the institution and the realization of its assets. As to rehabilitation:

> legal control over the bank's assets may be vested in a *conservator* (usually the bank supervisory agency, such as the FDIC in the United States, or the central bank in Argentina). The conditions that prompt the appointment of a conservator can include technical insolvency, actions by management that violate the bank's charter, inability to cover maturing obligations, or the presumption of fraud or mismanagement on the part of bank officials or directors. The conservator is charged with operating the bank as a going concern and with investigating its financial condition. Once the investigation is complete, the conservator evaluates the various options for recapitalization and decides which one to pursue. In this role, the conservator makes an offer to each class of creditor and typically has discretion to issue new equity and deposits or to initiate liquidation procedures.[42]

Sometimes a combination of techniques is necessary. In the case of Barings, the Bank of England placed the bank in the U.K. equivalent of conservatorship (administration) and, in a successful conclusion to the affair, sold the banking business to the Dutch group ING a week afterwards. Liquidation is the last resort. In many countries, bank liquidations are subject to ordinary insolvency law principles. In others, such as Austria, the Netherlands, and the United States, bank bankruptcies are covered by separate legal regimes.[43]

Conclusion

Is banking becoming more risky? One problem in answering this question is that it is hard to define what "banking" is anymore. There is a notable difference between the business of a small institution providing traditional deposit taking, loan, and money transmission services, and that of an international financial conglomerate active in a host of markets. The one need not be riskier than the other. For example, the small institution may be vulnerable to a slump in property values, which the large international bank can shrug off.

Nevertheless, risks need to be taken seriously. The sheer complexity of the contemporary international financial system can be bewildering. If the management of a bank like Barings did not understand their own business, how were depositors expected to make reasoned judgments?

All this puts an increased onus on regulators. Development of international standards is undoubtedly one way forward. At the same time, there is a need to avoid regulatory overload. An unfortunate side effect of more visible regulation is that public expectation may have been raised to unrealistic levels. Sound regulation is important. However, it cannot avoid disasters completely. In the end, now, as in the past, prudent management remains the essence of good banking.

Chapter

10 Internal Controls and Risk Management for Banks

10A. Supervision by Risk

JIMMY F. BARTON

Introduction

It seems that everyone these days—bankers, regulators, Congress, journalists, consultants—are all promoting the virtues of risk management, so much so that it is easy to get the impression that risk management is the latest fad in banking. However, the fact is that risk management has been around as long as the business of banking. Banks are—have always been and always will be—in the business of risk management.

For a number of reasons, however, risk management is more important than ever before. Banking markets today are constantly affected by innovations; the increased use of technology; and a virtual explosion in the types, volume, and velocity of financial transactions. Banks face unprecedented domestic and international competition not just from other banks but from a growing arena of financial institutions. Banks are surrounded by a legal environment of constant change. Due in part to some of these same factors, the risk-management systems available to banks have also improved. Advances in risk-management theory and in technology, taken together, allow banks to identify, measure, monitor, and control risk more effectively. Technology has also enabled faster communication and data transmission, allowing more timely risk measurement and thus enhanced risk management across a banking company's global operations.

The bank regulators' role is to ensure the safety and soundness of the banking system. Therefore, it is essential that bank regulators respond to the increased potential for risk. It is equally essential that bank regulators do this in a way that is the least intrusive and least costly way possible, in order to enable banks to thrive in today's competitive environment. The key to meeting the challenge of ensuring the safety and soundness of the banking system, while balancing risk versus reward, is for bank regulators to focus on the risk-management systems of banks. The Office of the Comptroller of the Currency (OCC), which supervises national banks in

the United States, is doing this through a program called "supervision by risk."[1] This chapter answers the following questions:

- What is supervision by risk?
- Is supervision by risk a change?
- What are the benefits of this philosophy for banks?
- What do bankers need to do in light of the OCC's changes?
- What still needs to be done by the OCC?

What Is Supervision by Risk?

Supervision by risk is best described as an evolution, not a revolution, in the OCC's supervisory practices. It can be characterized as a blending of a past philosophy—supervising based on risk—and a new structure to accomplish supervision. Supervision by risk requires both bankers and examiners to break the paradigm that evaluation of risks occurs only vertically. Rather, supervision by risk focuses the banker and the examiner on the identification and evaluation of risks across all product lines and activities. Supervision by risk is both a horizontal and a vertical assessment of risks. It can be broken down into several key categories or steps:

- First, identifying risks using common definitions. The OCC has defined nine risk categories. This set of risk definitions forms the cornerstone for its supervision relative to each bank or banking company. These definitions will form a consistent, common language for examiners to follow and bankers to understand.
- Second, measuring and evaluating risk based on common evaluation factors. Now that a common set of risks has been identified, the OCC has also developed an internal OCC process designed to assess risks, in a common evaluation format, again in an effort to improve consistency. This is the risk-assessment system.
- Third, developing a supervisory strategy based on risk and performing examinations based on this strategy. The OCC's supervisory strategy for each institution will be based on the conclusions from the risk-assessment system.
- Finally, documenting conclusions and communicating findings to bank management and the board. Open, two-way communication is fundamental to the entire supervisory process.

Risk Identification

Banking risk is defined generally as the potential that events, whether expected or unanticipated, may have an adverse impact on a bank's capital or earnings.

Risk by itself is not a reason for concern. Risk is necessary for reward. When discussing risk, however, several questions often arise: How much risk is enough? How much is too much? How should risk be managed? What if events do not happen as planned? Generally, risks are warranted if they are understandable, measurable, controllable, and within the bank's capacity to readily withstand adversity. In other words, risks are warranted if they are subject to effective risk-management systems.

As previously mentioned, the OCC has identified nine risks for bank supervision purposes: credit, liquidity, interest rate, price, foreign exchange, transaction, compliance, strategic, and reputation risk. Why these nine risks? The OCC reviewed the risk categories tracked by a number of large banks and financial institutions. It found that no consistent language or categories were used. The OCC has also learned from its examiners that greater precision is important in supervising risks because it provides more direct and specific communication and greater flexibility in tailoring supervision to each institution. The nine-risk framework provides the OCC with a comprehensive picture of the risks associated with banking as it exists today, while also looking at the issues facing the banking industry in the foreseeable future.

The OCC is often asked if all of these risks have equal impact on earnings and capital. Certainly not. The impact of each will vary by bank and may change within a bank or company over time. Furthermore, it is obvious that some of these risks are subsets of other, more commonly known risks. For instance, interest rate, price, and foreign exchange risks are often called "market" risk. The OCC broke these risks into nine categories to give flexibility and greater precision in its supervision.

The OCC also had a lot of questions about the identification of strategic and reputation risk as separate risks. These risks are included in order to have a set of risk categories that represent the entire risk profile of a bank. The OCC does not actively supervise or examine for these two types of risk in the same manner as the other seven, but it needs to consider them in order to have a thorough risk assessment of each institution.

The risks in various categories are interrelated. Any bank product or service generally exposes the bank to a number of risks simultaneously, and these risks often influence one another. For instance, it is difficult to determine directly the exact level of credit risk versus interest rate risk in a loan. Supervision by risk emphasizes that it is not necessary or important to distinguish a precise amount of each risk in a particular product or service, but rather to be aware that various risks are present and assessed. Again, supervision by risk is a new paradigm that focuses on a global evaluation of the risks.

The Risk-Assessment System: General Information

Once the risks have been identified, the next stage to ensure effective supervision is to develop a common framework to document decisions about those risks. This common framework to guide and record an examiner's analysis is known as the risk-assessment system. This system provides a concise method for communicating and documenting judgments for the nine risks. While the OCC has developed this overall philosophy for assessing and documenting risks, it is important to note that certain aspects of the risk-assessment system will vary, depending on whether or not the bank is a large or a community bank and/or whether strategic and reputation risk or one of the other more explicit risk categories is being addressed.

The Risk-Assessment System for Large Banks

In the risk-assessment system for large banks (those banks with total assets of $1 billion or more), examiners will make several decisions. These decisions relate to:

- the quantity of risk;
- the quality of risk management;
- the aggregate and composite risk; and
- the direction of risk.

Quantity of Risk

First, examiners must make judgments about the quantity of risk. Quantity is the level or volume of existing risk. The quantity of risk is labeled as high, moderate, or low. Quantity implies measurement. Banks are using and enhancing measurement tools, including models, on a more frequent basis. This enhances both the bank's and the OCC's ability to quantify these risks. The OCC also recognizes, however, that not all banks have or need sophisticated systems to quantify each risk. That sophistication and need for systems must be evaluated on a bank-by-bank basis. The OCC also recognizes that "measurement" does not always mean to quantify these risks in direct dollar terms or percentages. For example, quantification of transaction or compliance risk is not easily accomplished in terms of dollars and cents. The OCC does feel, however, that these two risks can be quantified in relative terms.

Quality of Risk Management

The next part of the decision process requires examiners to make conclusions about the quality of risk management. The quality of risk man-

agement is measured as weak, acceptable, or strong. Risk management is an internal bank process that does more than simply measure the quantity of risk. It is a process that is forward looking and proactive. An effective risk-management process must identify, measure, monitor, and control risks. The process should add value to the company by providing consistency, a proactive culture, effective communication, and coordination throughout the organization. It does not have to be an independent unit within the bank, such as an auditing unit. Regardless of how it is structured, risk management is a process that understands the culture, the risks, and the interrelationship of the risks within each company.

Aggregate and Composite Risk

The third stage in the risk-assessment system is for examiners to make a decision on aggregate risk. The aggregate risk reflects the level of supervisory concern, considering the quantity of risk in a particular area weighed against the quality of risk management. The OCC categorizes aggregate risk as low, moderate, or high.

At this stage of the decision process, the treatment of the remaining two risks—strategic and reputation risk—can be examined. The OCC does not require a separate quantity/quality decision for strategic and reputation risk. These risks are more implicit and cannot be readily quantified. The OCC does make a decision, however, on the level of supervisory concern for these two risks. This is called composite risk, and it is categorized as low, moderate, or high. Composite risk is similar to aggregate risk except that it is more one dimensional.

Direction of Risk

The final decision that examiners make for large banks is to determine the direction of risk for all of the nine categories of risk. Direction of risk reflects the likely changes to the aggregate or composite risk profile over the next 12 months. Direction is described in terms of increasing, stable, or decreasing. Direction does not necessarily mean that the aggregate risk will move from one level to another in 12 months. Direction means that the aggregate risk is trending up or down, or remaining unchanged. Assessing the direction of risk helps the examiner to determine and refine the supervision activities for the bank.

The Risk-Assessment System for Community Banks

Similar to the composite risk decision made for strategic and reputation risk in large banks, examiners will make only one decision for communi-

ty banks. The decision reflects the level of supervisory concern for each of the nine risk categories. The aggregate or composite decision does not directly require a decision on quantity and quality of risk management. The OCC does not ignore the quantity of risk and quality of risk-management factors; rather they are blended into a single decision process. The OCC categorizes this aggregate and composite risk for community banks as low, moderate, or high.

Examiners also will determine the direction of risk in community banks for all nine categories of risk. The same concepts discussed previously for large banks apply to the direction of risk for community banks.

The Risk-Based Strategy

The third step in the supervision-by-risk philosophy is that of a risk-based strategy. A key advantage of using the risk-assessment system for the OCC is that it helps the examiner plan examination activities. The decisions from the risk-assessment system form the foundation of its strategy for each bank. The OCC will focus its examination efforts on the areas of greatest risk in the institution and use only minimum procedures in areas of low risk.

For large banks, which are more complex and diverse, the OCC focuses more on risk management. The risk-management examinations will be supplemented with some transaction testing or validation, depending on the risk present.

For community banks, which are less complex and diverse and typically present traditional banking risks, OCC examiners start with performance-based testing. Performance-based testing confirms the use of sound fundamental principles in a bank. Performance-oriented testing is appropriate for low-risk areas commonly found in noncomplex community banks, provided that the risk areas are appropriately managed and controlled. The OCC's Community Bank Procedures for Noncomplex Banks, introduced in June 1994,[2] represent its first step in establishing minimum procedures. In areas of low risk, the OCC will continue to use only those procedures and place emphasis on performance. In areas of higher risk, the OCC will look much more closely at the risk-management process.

Communication

The last phase of the supervision process is that of communication. Although communication is listed as the last phase, effective communication is integral to the entire supervisory process. It can take the form of

the report of examination, board meetings, entrance and exit meetings, or any other form of communication, such as phone calls, correspondence, or outreach meetings.

The OCC has outlined minimum standards for what examiners must communicate to bankers. Among other items, examiners should discuss the overall condition; the significant risks that the OCC, or the management team, have identified for the institution; the OCC's examination plans or strategy for the next supervisory cycle; and the OCC's preliminary and final conclusions from the risk-assessment system.

Communication is only effective if it is an open two-way process. Bank management and directors must be willing to share with examiners information and comments on the risk-assessment system and the examiner's conclusions. Bankers should ask questions or provide comments on various aspects of the OCC's evaluation of the bank's risks.

To illustrate how all this information is tied together, the following is a brief synopsis of the supervisory cycle within the supervision-by-risk process. The OCC first develops an initial risk assessment for each bank or company using the risk-assessment system. Using this initial risk assessment, it will develop a supervisory strategy to outline its examination scope. The OCC will perform its examinations, which then provide additional information. This improves the accuracy of the risk-assessment profile. Using this risk-assessment profile, the OCC is better able to draw conclusions on the quantity of risk and the quality of risk-management systems. This will, in turn, allow it to make better decisions on capital adequacy, better classify the banks it supervises, and allocate its resources accordingly. The process of assessing risk and adjusting OCC supervision accordingly is a continual one. Communication with bank management occurs throughout each stage of the process and is critical to effective supervision.

Is Supervision by Risk a Change?

Is the Supervision by Risk program similar to what the OCC has been doing in national banks? Is it a change or not?

The theory of supervising banks based on risks, developing supervisory strategies in response to the identified risks, and emphasizing communication in its examinations are fundamental elements of good bank supervision that the OCC has long practiced. Supervision by risk, however, does make some important changes that the OCC feels will enhance its ability to effectively and efficiently continue to supervise national banks.

Specifically, supervision by risk

- adds a common language and a structured process for examiners to use in assessing risks;
- provides an analytical framework for the OCC to use in deciding where to focus resources—in individual banks as well as for the national banking industry as a whole; and
- lays the foundation for the communication between examiners and bankers to be based on risk management.

Just as important as describing what supervision by risk is or what changes the OCC is implementing based on this philosophy is the need to clarify a few misconceptions. First, supervision by risk does not try to eliminate all risks in the banking system. The OCC does not expect risk to be eliminated—some degree of risk is fundamental to any business. However, the OCC does expect risks to be managed.

Second, supervision by risk is not a substitute for CAMEL, which is the acronym for the five elements of the Uniform Financial Institutions Rating System: (i) capital, (ii) asset quality, (iii) management, (iv) earnings, and (v) liquidity. Supervision by risk and CAMEL ratings exist in tandem. CAMEL uses actual performance to derive a conclusion about a bank's current condition, while supervision by risk focuses supervisory attention on the area or areas of current and emerging risk. In other words, the OCC will continue to assess the bank's condition on performance, yet it will plan the areas of the bank to be examined and assign the resources needed to accomplish this task by identifying and measuring risk. There is also an interagency bank regulatory effort under way that is working on amending CAMEL to include risk management.[3] The interrelationship of CAMEL and supervision by risk will be reevaluated once these changes are made.

Finally, supervision by risk does not mandate that every bank adopt one risk-management system or the OCC's exact definitions. Risk management remains the responsibility of bank management and the board of directors. The bank's risk-management system may differ from that described herein. A bank's management and its directors should evaluate its risk-management system to ensure its effectiveness.

What Are the Benefits of Supervision by Risk for Banks?

What benefits does supervision by risk have for the banks? Does it just create more regulatory burden? The OCC does not think so. While supervision by risk is the linchpin for OCC's supervision of the national

banking industry, the OCC firmly believes that the concept of effective risk management, which is fundamental to the supervision-by-risk philosophy, is simply good business for banks.

The OCC also thinks that there are tangible benefits to banks from this approach. First, it focuses examiner attention on items of significance. In areas where a bank effectively manages risk, examination activities will be minimal. Second, communication between bank management, directors, and the OCC will be more focused because the parties will share a common language and concentrate attention on what concerns bank management and the OCC most. Third, risk management focuses on adding value to the organization. Risk management is a process that understands the culture, the risks, and the interrelationships of these risks within each individual company. It does not simply add another costly layer of management in the organization. It is a culture that emphasizes basic concepts and increases the financial institution's strength. Finally, supervision by risk recognizes that the responsibility for managing risks rests with the bank. Supervision by risk does not require any particular organizational structure or particular systems to manage these risks. The OCC simply wants bank management to manage the risks effectively. As supervision by risk evolves at the OCC, it will provide national banks with enhanced peer analysis that focuses on risk and risk management.

What Must Bankers Do in Light of the OCC's Changes?

There are two critical elements that deserve attention: first, the definitions of risk; and, second, the concept of risk management.

Definitions of Risk

First, understanding the definitions of risk and their interrelationship provides some context for the supervision-by-risk philosophy. To assist in this process, a few examples of bank activities or products and the risks present in those activities are described.

The first example illustrates the interrelationship of risks: a fixed-rate ten-year U.S. government investment security that is held in a bank's held-to-maturity portfolio. It includes interest rate risk—if short-term rates increase, the bank's interest margins could decrease because the cost of funds would rise in relation to the security's yield. Liquidity risk is involved because of the costs involved in liquidating the bond, should that become necessary. If interest rates have increased significantly since management purchased the bond, the bank may incur unacceptable losses to sell the bond. Transaction risk also comes into play through the paperwork and wire processing of funds to buy and sell the security. In

addition, while the pieces are sliced equally in this representation of the risks, interest rate risk in a U.S. government bond may be larger than transaction risk. It is also important to note that one cannot always effectively evaluate risks on an individual bond or transaction basis. One bond itself may not appear to involve significant interest rate risk exposure, but when combined with the remainder of the bonds in the portfolio, interest rate risk may become significant. To properly assess risks, one must look at all assets and liabilities and their aggregate impact; risks from one product or activity may be mitigated by other products or activities.

To illustrate further the interrelationship of risks, a second example is a variable-rate term loan to a small business. Obviously, credit risk is involved, based on the possibility of default by the obligor. Even though the loan has a variable rate in this example, interest rate risk still exists. If interest rates fall sharply, for example, the borrower may decide it is feasible to refinance, thus leaving the bank with unexpected funds to reinvest in a lower-yield environment. Liquidity risk is again present because there would be a cost to the bank to sell this asset in a time of need. Compliance risk occurs based on whether or not the loan adheres to internal loan policies or possibly because of legal limitations. In addition, transaction risk can be substantial if the bank lacks adequate internal controls or systems to monitor the loan.

A final example involves mutual funds. Certainly a bank's decision to offer mutual funds involves various risks. Strategic risk is encountered based on bank management and the board's decisions to enter the business and what products they should offer. The decision makers should also consider initial capital outlays to establish the fund and to gain a breakeven customer base. Reputation risk becomes apparent when the funds fare poorly, because customers may associate any monetary loss with the salesperson placing them in the product. Reputation risk increases when the fund is a proprietary mutual fund, because customers will have a tendency to associate the product with the institution. Also, compliance risk arises because of the various legal, ethical, and contractual obligations and the number of regulatory agencies potentially supervising this area: the OCC, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the National Association of Securities Dealers. Liquidity risk may also be present if the funds perform poorly or if the bank itself encounters publicized problems. Customers of the funds, including institutional investors, can disappear quickly, and the bank could find itself providing actual liquidity to the fund from the bank. Transaction risk also occurs with every transaction and is heightened when the bank serves as the administrator or custodian of its own mutual funds.

These few examples illustrate the global risk paradigm versus mere product or activity risk assessments. It is important to remember that

products and activities have multiple risks, that these risks are interrelated, and that proper evaluation of risk requires a change from vertical product analysis to a horizontal assessment for the entire institution.

Risk Management

The OCC expects each national bank to establish or maintain an effective risk-management system. As previously noted, an effective risk-management system has four basic components: risk identification, risk measurement, risk control, and risk monitoring.

Because market conditions and company structures vary, there is no single risk-management system that works for everyone. However, each institution should have a system, whether formal or informal, that addresses each of these four areas. The level of sophistication of these systems should correspond to the size and level of complexity of the institution's operations and its competitive environment.

Most institutions already have some elements that are the basis for an effective risk-management system. For example, they probably have policies, whether formal or informal, that define risk philosophy. A common example is a policy that communicates the loan-to-value limits for the bank's lending staff. Each bank also has an internal process that allows management to analyze and monitor its balance sheet and income statement. Every bank also has personnel. They are constantly evaluated on whether or not they are performing as expected and whether or not they have the skills necessary to manage the bank's risks. In addition, every bank has some control systems in place, whether these involve segregation of duties, audit, or possibly a loan review function. The implementation of an effective risk-management system is not the creation of a whole new process. Rather, it should build upon some sound fundamental principles of effective management that already exist and evolve the bank's culture into one that views risks within the organization from a global perspective.

What Still Needs To Be Done by the OCC

At the OCC, supervision by risk will continue to evolve. The steps addressed above are simply the first steps to establish and implement fully supervision by risk. The OCC needed to develop a common language and consistent structure for assessing risks; these are critical to the evolution of its program. The OCC is committed to refocusing its examining culture to incorporate these concepts.

10B. Effective Tools for the Host Country Supervisor

STEPHEN M. HOFFMAN, JR.

Introduction

This chapter first describes the supervision program used by U.S. bank supervisory agencies, including the Board of Governors of the Federal Reserve System, for supervising U.S. operations of foreign banking organizations. It focuses on how the program enables these bank supervisory agencies, as host country supervisors, to identify supervisory concerns for communication to the banks and their home country supervisors. This, in turn, leads to the prompt resolution of those concerns and ensures the continuance of strong overall risk-management and internal control processes in the U.S. banking system.

Second, the chapter examines what can happen when a bank does not have adequate risk-management and internal control processes in place throughout the organization. Daiwa Bank and Barings are both recent examples of the consequences of failure to observe relatively simple, "low-tech" elements of risk management and internal controls. The chapter describes some of the conditions present at Daiwa Bank that made it possible for the bank to incur significant trading losses resulting from unauthorized activities that had gone undetected by the management of the bank, by its internal and external auditors, and by home and host country supervisors for over eleven years.

It would appear, based on the experience of U.S. bank supervisors with Daiwa Bank and Barings, that as ways to prevent these types of situations from occurring in the future are considered, any proposed enhancements must include increased attention on a global basis to a bank's risk management and internal controls. In order to evaluate fully a multinational bank's efforts at measuring and controlling risk throughout its franchise, the bank's home and host country supervisors must communicate regularly in coordinating their supervisory efforts. The Federal Reserve has a strong interest in coordinating its supervisory efforts with those of its bank supervision colleagues around the world in order to create an overall supervisory environment that more closely mirrors the business activities of the international banks that are collectively supervised.

The Foreign Banking Organizations Supervision Program

Foreign banks operate in the United States through various legal entities: branches and agencies, commercial banks, edge and agreement cor-

porations, commercial lending companies, representative offices, nonbanking subsidiaries, and frequently through multiple banking and nonbanking financial entities located in more than one state. In such situations, a number of state and federal banking supervisory agencies are charged with the responsibility of examining and supervising the particular entities comprising the foreign bank's multistate U.S. operations.

In 1995, the U.S. banking supervisors adopted a joint program for supervising the U.S. operations of foreign banking organizations (FBOs).[1] This program, which is referred to as the FBO supervision program, was developed through a cooperative effort among the agencies in order to provide a more comprehensive framework for supervising foreign banks' operations in the United States on a coordinated basis.

There is nothing radically new about this program. Most of the processes that comprise the FBO supervision program have been conducted by the different U.S. federal and state banking supervisory agencies for more than a decade. What is new is the level of coordination among the agencies. The program provides a highly defined framework within which the U.S. bank supervisors share information and coordinate both their supervisory assessment activities, including on-site examinations, and their evaluations of the results of these activities in order to develop shared supervisory conclusions and, where needed, remedial action measures. It is designed to enable U.S. supervisors to identify as early as possible any supervisory concerns relating to the U.S. operations of a foreign bank and to achieve their prompt resolution.

The FBO supervision program essentially seeks to develop and maintain an up-to-date supervisory view for the U.S. operations of each FBO, including a remedial action plan as necessary, that is based on all of the information available to the U.S. bank supervisors concerning the situation of the FBO itself as well as that of all of its operations in the United States.

Main Components of the FBO Program

The program has three main components. One component is the "strength-of-support assessment" (SOSA), which is an evaluation of the ability of the FBO to provide support, both financial and managerial, to its U.S. operations. This assessment process takes into account the financial condition of the FBO, the efficacy of its home country supervisory regime, and the home country's record of support for troubled depository financial institutions. The SOSA also takes into account any known developments affecting the FBO that may portend concerns with its risk-management processes, operational controls, or compliance programs. Examples of such developments are megamergers or the identification of

problems that indicate the existence of weaknesses in the risk-management processes of the foreign bank or the occurrence of significant breaches in its internal control environment.

The information developed through the SOSA contributes to the formulation of a supervisory strategy for the FBO's U.S. operations. In cases where the ability of the FBO to support its U.S. operations is in question, the SOSA process would, at a minimum, lead to enhanced monitoring of the asset and liability structure of the U.S. operations, together with close scrutiny of liquidity levels and funding capabilities, and, in extreme cases, could result in supervisory action to "ring fence" the U.S. operations to ensure, insofar as possible, that the U.S. operations are able to honor fully their market obligations by means of their own resources. In situations where weaknesses in the risk-management processes of the foreign bank have been identified or where there have been significant breaches in the bank's internal control environment, the result of the SOSA process would be an intensified examination of the FBO's U.S. operations in those areas identified as particular risks for the organization.

Second, the centerpiece of the FBO supervision program is the development of an annual comprehensive examination plan for each FBO's U.S. operations. This plan takes into account any issues identified through the SOSA process as well as any supervisory concerns raised in the previous round of examinations of the FBO's U.S. operations, particularly any issues identified as systemic in nature. In developing the comprehensive examination plan, the emphasis is on focusing examination efforts on those aspects of the FBO's U.S. operations that are seen as posing the greatest risk.

The third major component of the FBO supervision program is the development of an annual summary of the condition of the U.S. operations of each FBO. This evaluation is prepared following the completion of each round of examinations of the FBO's various U.S. banking and nonbanking operations. The preparation of this assessment facilitates the identification of issues that raise a significant degree of supervisory concern with respect to the FBO's U.S. operations viewed as a whole. This assessment is communicated directly to the FBO's head office senior management. In addition, any significant supervisory concerns are discussed with the FBO's home country supervisor.

It is important to emphasize that the various parts of the FBO supervision program should be viewed as a continuum. Each part is prepared in close conjunction with the others and is updated as developments warrant. Together, the various components give structure to the ongoing process of supervising foreign banks' U.S. operations and facilitate the early identification and prompt resolution of problems in those operations.

Enhanced Examination: The ROCA Rating System

Another significant development in the supervision of U.S. operations of foreign banks that has been put into place as a key part of the FBO supervision program is the enhancement of the examination process for U.S. offices of foreign banks. This enhancement is embodied in the risk management, operational controls, compliance, and asset quality (ROCA) rating system, as well as in the related branch and agency examination manual, which provides detailed guidance to examiners on the application of the new rating. The ROCA system replaces the previous rating, which focused heavily on the condition at a point in time of the branch or agency's portfolio of risk assets.

Risk Management

The first component of the ROCA rating system, risk management, or the process of identifying, measuring, controlling, and reporting risk, is an important function at any financial institution. In a branch or agency, which is typically removed from its head office by location and time zone, an effective risk-management system is critical in managing the scope of its activities and in achieving comprehensive, ongoing oversight by local and head office management. In the examination process, examiners determine the extent to which risk-management techniques are adequate to control risk exposures that result from the branch or agency's activities and to ensure adequate oversight by the local and head office management and thereby promote a safe and sound banking environment.

The primary components of a sound risk-management system are a comprehensive risk assessment approach; a detailed structure of limits, guidelines, and other parameters used to govern risk taking; and a strong management information system for monitoring and reporting risks.

The process of risk assessment includes the identification of all the risks associated with the branch or agency's balance-sheet and off-balance-sheet activities, and the grouping of them into appropriate risk categories, such as those reviewed in Chapter 10A. All major risks should be measured explicitly and consistently by branch or agency management. For example, a branch or agency would be expected to have systems for early identification of problem assets and the development of appropriate resolution programs. Risks should also be evaluated on an ongoing basis—underlying risk assumptions relating to economic and market conditions vary, and offices' activities change over time. Expansion into new products or business lines should not outpace proper risk management, including oversight by the head office. Where risks cannot be explicitly

measured, the management should demonstrate knowledge of their potential impact and a sense of how to manage such risks.

Risk identification and measurement are followed by an evaluation of the trade-off between risks and returns to establish acceptable risk exposure levels, which are stated primarily in the branch or agency's lending and trading policies that are subject to the approval of the head office management. These policies should give standards for evaluating and undertaking risk exposure in individual office activities as well as procedures for tracking and reporting risk exposure to monitor compliance with established policy limits or guidelines.

The head office management has a key role in developing and approving the branch or agency's risk-management system as part of its responsibility to provide a comprehensive system of oversight for that office. Generally, the risk-management system, including risk identification, measurement, limits, guidelines, and monitoring should be modeled on that of the FBO as a whole to provide for a fully integrated, institution-wide risk-management system.

Operational Controls

The second component of the ROCA rating system is operational controls. This component assesses the effectiveness of the branch or agency's operational controls, including those relating to the safeguarding of assets, accounting, and reporting. The assessment is based on the expectation that each branch and agency should have in place a fully effective, coordinated process of internal controls, including audit coverage, that is consistent with the size of the office and the complexity of its operations. In this regard, internal control and audit procedures should ensure that operations are conducted in accordance with both management requirements and regulatory policies, and that all reports and analyses provided to the head office and local senior management are timely and accurate.

This aspect of supervision in the context of branches and agencies is intended to achieve two basic goals. One goal is to ensure that the participation of foreign bank branches and agencies in the U.S. banking system does not undermine the efficiency of, and confidence in, the system. The second goal is to ensure that the head office management, and by extension the bank's home country supervisor, are able to supervise comprehensively the global operations of the FBO on a consolidated basis in accordance with the Basle supervisory principles.[2]

Compliance

The third component of the ROCA rating system is compliance. In addition to maintaining an effective system of operational controls,

branches and agencies should also demonstrate the existence of programs necessary to ensure compliance with all applicable state and federal laws and regulations, including regulatory reporting requirements.

Asset Quality

The final component of the ROCA rating is asset quality. Generally, asset quality is evaluated to determine whether a financial entity has sufficient capital to absorb prospective losses and, ultimately, whether it can maintain its viability as an ongoing entity. The evaluation of asset quality in a branch or agency does not have the same result because these offices are not separately capitalized entities. Instead, a branch or agency relies on the financial and managerial support of the FBO as a whole.

Nonetheless, the evaluation of asset quality is important both in assessing the effectiveness of credit-risk management and also in the event of a possible liquidation of the branch or agency. However, as just mentioned, these offices are not strictly limited by their own internal and external funding sources in meeting solvency and liquidity needs. The ability of a branch or agency to honor its liabilities ultimately is based on the condition and level of support from the FBO.

If the condition of the FBO is satisfactory, it is presumed to be able to support the branch or agency with sufficient capital and reserves on a consolidated basis. As a result, the assessment of asset quality in such circumstances would not in and of itself be a predominant factor in the branch or agency's overall assessment if existing risk-management techniques are satisfactory. If, however, the condition of the FBO is less than satisfactory and/or support from the FBO is questionable, the evaluation of asset quality is considered carefully in determining whether supervisory actions are needed to improve the branch or agency's ability to meet its obligations on a stand-alone basis. In cases where a branch or agency is subject to asset maintenance, it is expected that asset quality issues will be addressed by disqualifying or discounting high-risk assets as eligible assets. The level of problem assets at a branch or agency may be an indication of problems in credit policies, loan-origination practices, loan workouts, or loss-identification procedures. Generally, problems in these areas are addressed in the risk-management component of the rating system.

Daiwa Bank

The preceding text addressed the procedures that U.S. bank supervisors use to assess a bank's ability to manage the risks associated with its business. Daiwa Bank is an example of what can happen when basic internal controls fail at a depository institution.

A breach of basic internal controls at the New York branch of Daiwa Bank caused the bank to incur $1.1 billion in trading losses resulting from unauthorized trading activities that were conducted from 1984 to 1995, over an 11-year period. A senior official at the branch was able to perpetrate this fraud because he had responsibilities for both custody and securities trading. Based on information available to U.S. bank supervisors at this time, it appears that he was able to hide his trading losses by selling securities that were held by the New York branch in custody for the bank and its customers. The official was able to conceal his trading activities by preparing false custodial account records and by never being absent from the bank for more than three consecutive business days over the 11-year period.

The information that U.S. bank supervisors obtained concerning both Daiwa Bank and Barings indicates a fundamental breakdown in relatively simple elements of risk management and internal controls. In recent years, there has been a tendency by both bank managements and supervisors to focus on "high-tech" aspects of risk management and internal control, that is, the identification, modeling, and loss-limit-control aspects of complex financial instruments. The events at both Barings and Daiwa Bank indicate that the failure to observe relatively simple aspects of risk management and internal control carries a heavy price. Unfortunately, depository financial institutions will always be vulnerable to the risk of hiring a "rogue" employee who has his or her own best interest at heart rather than the interests of the institution. Given the impact that these individuals can have on a bank's income and capital, banks should be self-motivated (and most are) to control the activities of individuals who are in positions to create large losses. Banks have a financial incentive to ensure that they have comprehensive risk-management and internal controls systems in place that allow them to identify, measure, control, and report the nature and the amount of risk that they are willing to assume. However, supervisors also have a duty to ensure the integrity of their financial systems by identifying breaches in internal controls or gaps in bank managements' policies and procedures at a point early enough to minimize damage.

With this goal in mind, U.S. bank supervisors have accelerated the implementation of the improved supervisory programs and risk assessment methodologies that have just been described in order to strengthen further their capability to oversee banks, both domestic and foreign, operating in the United States.

Worldwide Coordination of Supervisory Efforts

In the Barings and Daiwa Bank cases, both banks conducted significant activities outside of their home countries that were in large part managed

locally. This type of operating structure is not uncommon for a multinational bank. In cases where such a structure exists, it behooves the home and host country supervisors to communicate on a regular basis in order to coordinate their supervisory efforts. While informal conversations foster improved relations with one's fellow bank supervisors, this method of communication cannot continue to suffice as the best means of coordinating one's supervisory efforts with those of a fellow bank supervisor. The Federal Reserve is exploring ways to ensure better coordination of supervisory activities, including timely communication of material information, with foreign supervisors. In this regard, a number of international bank supervisors recently have indicated an interest in clarifying further their cooperative supervisory arrangements with the Federal Reserve. These efforts will enable the Federal Reserve both to learn more about the international operations of U.S. banks, thereby improving its effectiveness as a home country supervisor, and to share information on the U.S. operations of foreign banks, thereby meeting its responsibilities as a host country supervisor to communicate significant information to the home country supervisors of foreign banks operating in the United States.

Finally, the Federal Reserve, working together with the Basle Supervisors' Committee and other multinational supervisory groups as well as bilaterally with other international bank supervisors, will continue to devote even more of its attention to ensuring the adequacy of risk management and internal controls for internationally active banks. The objectives of this effort will be to determine with greater precision the bank supervisory policies and procedures relating to risk management and internal controls, including audit coverage, that are in place around the world; then to pursue the development of sound international practices, or possibly even minimum standards, for global risk management and internal controls by multinational banks.

Given the rapid advances in technology, the geographic expansion of bank activities, the globalization of financial markets, and the constant innovation in financial instruments, there is a greater likelihood that the problems of one internationally active bank will affect others. In an effort to counterbalance the increased risk of material loss for a large multinational bank, and more broadly for the international banking system, supervisors must vigorously coordinate their supervisory efforts when unsafe and unsound conditions exist. The supervisory methods that have just been described should be of benefit to all bank supervisors, as they seek to strengthen further the global network of comprehensive supervision of the operations of internationally active banks.

Chapter

11 Sharing of Information Between Supervisory Authorities

J. VIRGIL MATTINGLY, JR.

Introduction

Technology has radically altered the manner in which banking is conducted. Limitations of time and geography generally have been erased by instant communications systems and global computer linkages. These technological advances allow banks to respond immediately to market demands and to offer customers increasingly complex and innovative financial products.

One consequence of these developments is that cross-border business by international banks has grown in both volume and complexity. As banks engage in more activities globally, their national identities do not necessarily reflect the location of much of their business or the nature of their regulation. This situation poses new and difficult challenges for bank supervisors. As a result, there is increased urgency for supervisors of financial institutions to assist one another in understanding the risks undertaken by internationally active banks. More than one episode in this decade has illustrated the perils of failing to do so.

This chapter examines why information sharing between supervisors has become an area of such critical importance. To illustrate some of the legal issues raised by the sharing of confidential supervisory information, a number of provisions of U.S. law relating to the collection and dissemination of information are summarized. In addition, this chapter reviews briefly some of the experiences of the Board of Governors of the Federal Reserve System with respect to sharing information and the ways in which the Board has sought to balance the many competing interests in this area.

Why Share Information?

The threshold question is why information sharing between supervisors in different countries has taken on such importance. Banks are and always have been regarded as unique and important institutions. They serve a vital role in a nation's economy by virtue of their activities as

financial intermediaries and as the vehicles through which monetary policy is implemented. Many countries have learned to their regret the consequences of not adequately supervising banks and other deposit-taking institutions for adherence to prudential banking standards. Although banks can and should be allowed to fail for their own market-based decisions, every effort should be made to prevent bank failures resulting from inadequate banking supervision. Bank failures can cause shocks to the financial system as a whole by draining public funds, causing depositor losses, and leading to a general lack of confidence that can slow economic progress or recovery.

Banking institutions thus are generally subject to a high degree of supervision and regulation in order to preserve the health of the banking system and the economy. Until fairly recently, supervisors could achieve this goal largely within the borders of a single country.

The financial marketplace, however, is rapidly evolving. Computers and telecommunication satellites have lowered the cost and broadened the scope of financial services. Technological innovation, in turn, has accelerated the second major trend—financial globalization. Both developments have stimulated cross-border holdings, trading, and credit flows. In response, financial institutions have expanded their cross-border operations both for their own accounts and in order to serve an increasingly global customer base.

This expansion is not always seamless in terms of organizational structure. For example, a bank may not be able to establish branches in some jurisdictions. In others, a separate subsidiary may be required by local law or policy, or may be desirable for business management reasons. In still other jurisdictions, local law may require operation through a joint venture with a local partner. In all jurisdictions, tax considerations will have a bearing on organizational form. The result can be a highly complex banking structure with dozens or even hundreds of subsidiaries and affiliated companies. Most of the legal entities within such structures will be subject to some form of regulatory regime, which may impose requirements different from, and at times conflicting with, home country regulatory requirements. Complicating the matter is the fact that many banks now centralize their risk-management systems along business lines, as well as across legal entities. This has been the case particularly in the United States.

For these reasons, the challenges of supervising an international bank are greater today than at any time in the past. One response to these challenges is to ensure that each international bank has a home country regulator that is willing and able to exercise comprehensive supervision over the consolidated worldwide operations of the bank. The standard of con-

solidated home country supervision has achieved general acceptance throughout the world, as evidenced by the adoption of the Minimum Standards on Consolidated Supervision[1] by the Basle Committee on Banking Supervision and by ongoing efforts in most countries to adopt or improve systems of consolidated supervision.

The most famous—or infamous—example of a banking structure that was not subject to appropriate consolidated supervision was the Bank of Credit and Commerce International (BCCI).[2] BCCI managed to elude prudential supervision through its use of a fragmented, unsupervised structure operating in foreign jurisdictions with minimal supervision and strong bank secrecy laws. Although BCCI was headquartered in Luxembourg, Luxembourg did not supervise BCCI on a consolidated basis, thereby allowing BCCI to escape normal banking oversight. BCCI's activities eventually encompassed subsidiaries, branches, and affiliates in 69 countries, with the largest concentration of local deposits in the United Kingdom. The dangers of this form of unregulated operation were recognized by the late 1980s. At that time, there were efforts among various supervisors to come together and share information on BCCI's operations. These efforts may have helped bring to light the unsafe banking practices and associated criminal activities of BCCI.

The U.S. Congress enacted the Foreign Bank Supervision Enhancement Act, in large part as a response to the collapse of BCCI. The Act requires that any foreign bank that proposes to conduct a banking business in the United States must be subject to comprehensive supervision on a consolidated basis.[3] Under this standard, the Board examines the home country supervisory system and takes into account whether the bank's structure presents barriers to effective supervision.[4] The Board also considers whether the home country supervisor can share information with the Board if necessary in the supervision of the bank's U.S. operations.[5]

Even the most comprehensive system of consolidated home country supervision, however, may not be sufficient to deal effectively with the increasingly diverse and widespread operations of internationally active banks. Two more recent cases, both of which were widely reported in the press, demonstrate the importance of cooperation among supervisors. On November 2, 1995, the Board, along with other federal and state banking regulators, ordered Daiwa Bank to close its operations in the United States.[6] At the same time, federal criminal charges were brought against the bank and certain bank officials.[7] Both of those actions were in response to Daiwa's concealment of trading losses of approximately $1.1 billion from unauthorized trading of U.S. treasury securities at Daiwa's New York branch from 1984 to 1995.

The disclosure of the dramatic trading losses in September 1995 was the climax in an unfortunate progression of deception and concealment that had begun in 1984. Less than a month after Daiwa informed the Federal Reserve about the losses at its New York branch, Daiwa reported that its subsidiary bank in New York, The Daiwa Bank Trust Company, had incurred losses of $97 million between 1984 and 1987 as a result of trading activities, some of which were unauthorized. The transactions were undertaken through an offshore subsidiary to hide the trading losses from the Federal Deposit Insurance Corporation, the New York State Banking Department, and the public. In 1993, in response to examiners' expressions of concern about the dual capacities of a senior vice president in charge of custodial services who also traded securities at the branch, a senior official at the bank provided written confirmation that the supervision of those two areas had been separated. In fact, the senior vice president continued to operate in his dual capacity.

With that as background, it is hardly surprising that the U.S. authorities would regard the events of the fall of 1995 as the last straw. Even standing alone, however, the handling of the branch's losses was sufficiently egregious to demand a strong response from U.S. regulators. Senior management of Daiwa had been advised of the problems in July of 1995 and had failed to inform the appropriate authorities. Moreover, they took steps to conceal the events in question from U.S. regulatory authorities. Daiwa's July 1995 quarterly report to the Federal Reserve System failed to reflect the misappropriation of securities from custodial accounts undertaken to cover and conceal the trading losses.

With hindsight, greater openness and sharing of information between U.S. and Japanese authorities might have revealed these activities sooner, and the story could have had a different ending. Indeed, a valuable lesson from the experience has been the importance of better coordination and timely communication of material information between supervisors.

Although Daiwa was required to terminate its U.S. operations, it did not fail as a result of the trading losses. Barings Bank, the London investment house, was not so fortunate.[8] Barings was brought down by the unauthorized trading activities and trading strategy adopted by the chief trader of Baring Futures (Singapore) Pte Limited. Again with hindsight, the failure of Barings might have been preventable if information available to the various exchanges and supervisory authorities in Singapore and Japan had been divulged at an early stage to authorities in the United Kingdom. Largely in response to issues raised following the Barings failure, a number of exchanges and clearing houses signed an international information-sharing agreement that will enable them to share both market and financial information about member firms.[9]

The Concordat

The call for greater coordination between banking supervisors in different countries is not a recent phenomenon. In the mid-1970s, the Basle Committee on Banking Regulations and Supervisory Practices, as it was known, adopted common principles for the supervision of banks' foreign establishments through a broad set of guidelines known as the Concordat.[10] In a 1990 supplement to the Concordat, the Committee stressed that supervisory authorities should undertake to cooperate with supervisory authorities in other countries on all prudential matters pertaining to international banks.[11] The Basle Committee also noted that national bank secrecy provisions may act as a constraint on the ability of regulatory authorities to cooperate and proposed that those countries whose secrecy requirements impede the disclosure of information should amend their banking secrecy requirements. In its supplement to the Concordat, the Basle Committee made a number of recommendations with respect to promoting adequate information flows between banking authorities.[12] For example, it recommended that if a host authority has reason to suspect problems of a material nature in a foreign establishment, such authority should inform the home country supervisor.[13] Moreover, supervisory authorities should have the right to gather information from the cross-border banking establishments of the banking organizations for which they are the home country supervisor. In this regard, it should be noted that some countries do not permit inspections by home country supervisors. The Basle Committee also expressed its view that information that has been shared should only be used for purposes of prudential supervision of financial institutions and that the confidentiality of information transmitted should be protected.[14]

To summarize, a local supervisory approach no longer is sufficient in a world where banks operate globally. Supervisors cannot ignore the fact that events in distant locations have the potential to bring down a bank at home. They must exercise greater vigilance and rely on a wider range of sources of information than in the past. As a supplement to auditors' reports, and examinations and inspections carried out by the home country supervisor, it is essential to obtain information from host country supervisors.

U.S. Laws Dealing with the Collection and Disclosure of Confidential Financial Information

An issue that naturally arises in connection with information sharing is bank secrecy or customer confidentiality.[15] All countries, to a greater or

lesser extent, have laws that protect the confidentiality of customer information. These laws should not, however, be allowed to interfere with the supervision of banks operating internationally. In this regard, it may be instructive to look briefly at some of the U.S. laws governing the collection and dissemination of information by the U.S. federal government in general and the U.S. banking agencies in particular. This summary will show how U.S. law seeks to balance the privacy rights of customers with the legitimate interests of supervisors and law enforcement authorities.

The United States is not a "secrecy jurisdiction." Banks do not offer numbered or anonymous accounts. Nonetheless, U.S. law does recognize that individuals and businesses have certain expectations and rights with respect to the confidentiality of financial and business information. A number of different statutes seek to guard those legitimate privacy interests.

The Trade Secrets Act

The Trade Secrets Act imposes criminal sanctions on government employees who disclose business and financial information that has been obtained by a government agency unless such disclosure is "authorized by law."[16] The scope of the types of information covered is extremely broad and includes virtually all commercial or financial data collected by an agency.[17] The precise meaning of the phrase "authorized by law" in the statute has been much litigated, and, as to certain narrow issues that are beyond the scope of this chapter, the judicial precedents are not conclusive.[18]

There is nothing in the legislative history specifically addressing the intentions of Congress in enacting the provision. Courts interpreting the statute have suggested that Congress was motivated by its recognition that the increased access by governmental agencies to financial records and commercial operations of individuals and entities—access that was necessary to effective regulation and supervision—had to be accompanied by some restraint on the freedom of governmental employees to disseminate such data to third parties.[19]

As previously noted, the Trade Secrets Act only prohibits the disclosure of business information if there is no clear legal authority to disclose such information.[20] Two statutory provisions permit disclosure by the Federal Reserve Board and other federal banking agencies to foreign banking supervisors.[21] One permits the sharing of supervisory information[22] and the other permits the federal banking agencies to assist a foreign supervisor in an investigation.[23] These statutes are addressed in more detail below. There are also, of course, several laws that authorize the sharing of information among supervisory authorities in the United States.[24]

The Right to Financial Privacy Act of 1978

The Right to Financial Privacy Act of 1978 (excerpts of which are set out in Appendix V (1) of this volume) governs both how government agencies obtain information from financial institutions and under what circumstances they may disclose such information to other government agencies.[25] In contrast with the Trade Secrets Act,[26] the Right to Financial Privacy Act concerns only customer records of individuals (or small partnerships) at financial institutions.[27] Moreover, it regulates information transfers only to government authorities.

The overall purpose of the Right to Financial Privacy Act is to protect individuals who are customers of financial institutions from unwarranted intrusions into their records by the government. The Act provides, generally, that a financial institution may only disclose the financial records of a customer to government authorities in limited circumstances, such as when the customer authorizes disclosure of his or her records or in response to subpoenas or search warrants that comply with the requirements of the Act.[28]

Financial records that one government agency has obtained in accordance with the Act can only be transferred to another agency if the transferring agency certifies that the records are relevant to a legitimate law enforcement inquiry within the jurisdiction of the receiving authority.[29] The customer whose records are being transferred must be notified.[30]

Although protection of customer records is the primary goal of the statute, the Act also recognizes that bank supervisors need full access to records at the institutions they supervise. Accordingly, the requirements of the Act do not apply to the disclosure of financial records or information to supervisory authorities, such as the Federal Reserve Board, that are exercising supervisory, regulatory, or monetary functions with respect to a financial institution.[31] Moreover, the Act also excepts from its requirements the exchange of financial records or other information among U.S. supervisors of financial institutions and the Securities and Exchange Commission.[32] In sum, the Act does not impede the Board's ability to collect information in its supervisory capacity and, as will be addressed further, to disclose such information to foreign bank regulatory or supervisory authorities.

The Common Law/Privacy Act

Two additional aspects of U.S. law relating to the privacy of customer records are worthy of mention. First, U.S. common law recognizes that the contractual duty of secrecy owed by a banker to his or her client can

only be superseded in limited circumstances, such as when the customer consents or when disclosure is compelled by law.[33] Second, with respect to records on individuals in the possession of government agencies, the Privacy Act of 1974 restricts disclosure of personally identifiable records maintained by government agencies.[34] Generally, the restrictions in this Act only apply to information in government records that are retrieved by the name of the individual.[35] Since most Board records relating to supervisory matters are identified and retrieved by the name of the relevant financial institution, this Act is of limited relevance to the topic of this chapter, and it is mentioned only as an example of the privacy protections afforded by U.S. law.

The Freedom of Information Act

Another important statute relating to information flows is the Freedom of Information Act (FOIA).[36] Although this statute would not furnish the mechanism for sharing information between supervisors, it is relevant to the movement of information in and out of U.S. government agencies. In addition, as addressed further, the FOIA may, in limited circumstances, prevent U.S. banking agencies from maintaining the confidentiality of certain types of information that have been provided to it by other supervisors.

Generally, the FOIA requires government agencies to disclose information in response to requests from the public.[37] The requirement, however, is not absolute. The Act contains nine exemptions that reflect a sensitivity to the privacy interests of individuals and businesses.[38] More specifically, the Act exempts from disclosure confidential information in the possession of a government agency.[39] Confidential information for this purpose includes confidential business information as well as information gathered in confidence by bank examiners.[40] It also includes certain types of personal information.[41]

Statutes Authorizing Disclosure to Foreign Supervisors

As previously noted, the Board is authorized by statute to share supervisory information with foreign banking supervisors and regulators.[42] The authority to share information under this provision, however, is not unconditional. The Board must first determine that such sharing is "appropriate" and that it "will not prejudice the interests of the United States."[43] There is also a confidentiality component that requires the Board to obtain, to the extent necessary, the agreement of a foreign authority receiving information to keep such information confidential to the extent possible under applicable law.[44]

The statute provides that the sharing may take place "[n]otwithstanding any other provision of law."[45] Also, the statute explicitly authorizes sharing only with banking regulators and supervisors,[46] and does not authorize sharing confidential information directly with foreign securities regulators or law enforcement authorities.

A different statutory provision allows the federal banking agencies to investigate and collect information at the request of a foreign banking supervisor.[47] In deciding whether to provide this type of assistance, the Board must consider whether such action would prejudice the public interest of the United States and whether the requesting authority has agreed to provide reciprocal assistance.[48]

Circumstances in Which the Board Cannot Keep Information Confidential

A recurring issue in discussions on sharing supervisory information is the ability of the recipient to maintain the confidentiality of such information. The Board recognizes this concern and will always strive to keep such information confidential to the full extent permitted by law. In this regard, it may be instructive to note the few circumstances in which the Board would be compelled to disclose information.

If confidential information is subpoenaed by a court, a grand jury, or Congress, the federal banking agencies may be required to disclose it. In addition, although the Freedom of Information Act exempts confidential information in the possession of a government agency from its disclosure requirements, the Act also permits a person to sue a government agency if the person disagrees with that agency's determination that particular information is confidential under the Act.[49] The court deciding such case may order the agency to provide the information.

In addition, the federal banking agencies may be obligated to provide relevant information to the Securities and Exchange Commission when they have concerns that the activities of certain entities or their affiliates pose a threat to a registered broker-dealer.[50] Finally, the Board is obligated to notify and provide relevant information to various U.S. law enforcement authorities in appropriate cases in connection with criminal law enforcement investigations.

Summary of Laws on Collection and Disclosure of Confidential Information

Based on this brief summary of U.S. laws governing the collection and disclosure of confidential information, it should be apparent that this is a

complicated area of law. The Board is continuing its efforts to clarify existing laws and to suggest additional legislation as appropriate. The Board's goal in such efforts is to increase its ability to engage fully in the kind of cooperative arrangements it believes are necessary in the changing environment.

The Board's Experience

There is general agreement that information sharing can only improve the effectiveness of supervision, a goal all supervisors have in common. At the same time, the Board, like other supervisors, considers that the needs of other authorities for relevant information must be balanced with the need to ensure that sensitive information is distributed to the smallest number of responsible people and used only for appropriate purposes.

As previously noted, the Board may share information with foreign banking supervisors and regulators.[51] The legal authority to share information, however, is not absolute. The Board must determine that such sharing is appropriate and obtain, to the extent necessary, the agreement of a foreign authority receiving information to keep such information confidential to the extent possible under applicable law.[52] Since 1992 when this provision was enacted, the Board has provided examination reports and other confidential supervisory information on request to foreign supervisors, making the determinations required by the law on a case-by-case basis.

On a more informal basis, representatives of the Federal Reserve communicate frequently with supervisors in other countries to discuss general supervisory topics as well as concerns about specific banking organizations. In addition, it has been the practice of the Federal Reserve to notify supervisors when there are specific concerns about the U.S. operations of a foreign bank supervised by such authority.

In 1995, the Board along with the other U.S. federal bank regulators, the Conference of State Bank Supervisors, and the New York State Banking Department inaugurated a program for supervising the U.S. operations of foreign banking organizations. Supervision of these operations is shared by the different federal banking agencies and the state banking agencies. The new Foreign Banking Organization (FBO) program seeks to reduce the duplication of efforts by supervisors and the regulatory burden on foreign banks. The FBO program has three basic components. It provides for the assignment of a risk ranking to each foreign banking organization; the assessment of the overall condition of the combined U.S. operations of a foreign banking organization through an annual examination; and, if necessary, the establishment and monitoring

of a supervisory remedial action plan. As part of this program, the Federal Reserve will be sending to the senior management of foreign banking organizations with U.S. operations a letter summarizing the condition of those operations. On a quarterly basis, the Board intends to send a letter to foreign supervisory authorities listing the banking organizations chartered in the authority's country and providing general information on the condition of the U.S. operations. Any matters of significant concern would be communicated directly and quickly to the home country authority. Home country supervisors would also be able to request copies of the reports of examination from the Board or obtain them directly from the foreign banking organizations.

Examples of somewhat more formal understandings between U.S. and foreign supervisors include a 1994 exchange of letters between the Board and the Comptroller of the Currency on the one hand and the German bank supervisors on the other.[53] Although not the primary subject of the informal agreement, the letters provide in broad terms for cooperation between the signatories and that information will be shared to the extent reasonable, subject to any relevant statutory provisions, including those restricting disclosure. In addition, under a 1988 agreement with the Securities and Investment Board (SIB) in the United Kingdom, the federal banking agencies and the New York State Banking Department have agreed to provide certain types of public information to the SIB.[54]

As previously noted, developments in the financial services sector and recent events have caused supervisors to recognize the need for more formal information-sharing arrangements. Accordingly, the Board has been working for some time to develop a form of agreement or understanding that can be used as the basis for sharing information with foreign authorities in the supervision of cross-border operations. Ideally, such an agreement should spell out the intentions of the parties with some specificity, but at the same time leave room for the balancing of potentially conflicting policy interests.

One of the main operative provisions of the understanding would call for notification based on "material supervisory concerns." This term is intended to cover matters relating to whether the operations of a banking organization are conducted in a safe and sound manner and conform with applicable prudential standards. The term also would encompass material violations of law and events that would have a material adverse effect on the financial stability of financial institutions in the country of the other supervisor.

The notification obligations of each authority would cover operations for which the authority is the host supervisor and the foreign operations of banking organizations for which it is the home supervisor. Put more

concretely, the Board would endeavor to notify and provide relevant information to the other authority when it had material supervisory concerns regarding U.S. branches and subsidiaries of the other authority's banking organizations and the branches and subsidiaries of U.S. banking organizations located in the other authority's country. There would be a reciprocal agreement by the other authority.

The sharing of information on a home-to-host basis can raise sensitive issues. When confidence in the integrity of a financial institution is shaken, public trust is affected and that institution, and potentially the financial system, can be weakened. Supervisors must therefore consider all of the potential consequences following from the disclosure of information. There may be situations where a supervisor who is dealing with a troubled banking organization reasonably believes that the problems can be contained and that no notification is necessary. In fact, there may be rare cases where actions taken by a host supervisor based on partial information could exacerbate the very problem that the supervisors are seeking to prevent.

Accordingly, it may be necessary to balance the competing interests of sharing on the one hand and maintaining market confidence in the particular banking organization on the other. To account for such balancing, it would be important to specify in the agreement that information on banking organizations for which each authority is the home country supervisor would only be provided in cases where such a banking organization is facing serious financial difficulties that could have a material adverse impact on its operations in the host country. Furthermore, the authorities would only disclose such information as appropriate, taking into account all relevant factors, including the status of efforts by the home country authority to resolve the banking organization's difficulties and to restore confidence in that organization.

The understanding also would provide for situations where one authority may have particular concerns about certain operations and may wish to obtain detailed information on those operations from the other authority. Reports of examination or inspection and other confidential supervisory information could be provided upon request.

Under the confidentiality provisions, each authority would agree to hold confidential all information received to the extent permitted by law. It is contemplated that both authorities would have already shared information about the legal regime governing the use and treatment of confidential information.

The understanding could also deal with more mundane issues, such as periodic meetings, and notification and cooperation with respect to

examinations and inspections conducted in the host country. Even in such seemingly routine matters, the discussions necessary to reach an agreement can be valuable because they require the parties consciously to define their relationship and responsibilities to each other.

Over the course of the next few years, the Board expects that its first efforts in this regard will be subject to refinement and modification. Therefore, it must be emphasized that the model outlined previously is not considered to be applicable universally. The purpose in going through some of the provisions is simply to suggest some possible approaches to various issues present in this important but complicated area.

Multilateral Initiatives

In the interest of completeness, it may be useful to mention briefly two multilateral initiatives concerning sharing of information between supervisors of different industries. Many banks operating internationally have subsidiaries that engage in securities or insurance activities, or are a part of a larger financial conglomerate that engages in a broad array of financial services. The banking institution may have transactions or relationships with its affiliates that are crucial to an understanding of the condition of, or the risks faced by, the bank. Consequently, the issues of sharing information across industry lines are being considered in two multilateral contexts.

One is a joint initiative undertaken by the Basle Committee on Banking Supervision and the International Organization of Securities Regulators (IOSCO) to improve the coordination between banking and securities regulators generally and to establish additional collaborative arrangements, including effective lines of communications, in the supervision of diversified financial groups.

The second initiative is the so-called Joint Forum, a working group composed of representatives of the Basle Committee, IOSCO, and the International Association of Insurance Supervisors. The purpose of the Joint Forum is to seek practical means at domestic and international levels to facilitate the exchange of information by supervisors of entities within financial conglomerates, and to work toward developing principles for the future supervision of financial conglomerates. These two efforts demonstrate the momentum that is building for enhanced cooperation among supervisors.

Conclusion

Changes in the way in which financial institutions are doing business require that supervisors cooperate in new ways. It is not possible to

overemphasize the benefits of establishing how such cooperation will be achieved prior to the occurrence of a situation where cooperation is crucial. Whether the sharing of information is pursuant to a memorandum of understanding, such as that described, or to a less formal document is not important. What will be increasingly critical in the years to come is for supervisors in different countries and different industries to consider how together they can preserve more effectively the integrity of financial institutions and the economies in which they operate.

COMMENT

KATHLEEN M. O'DAY

The issue of sharing information between supervisory authorities has some practical implications. This comment examines the topic from the different perspectives of (i) a home country supervisor and (ii) a host country supervisor. In addition, the comment addresses the issue of sharing information across industry lines in cases where a bank is part of a group that has different types of financial services institutions operating within the group.

Home Country Supervisor's Perspective

Home country supervisors care about sharing information because, in order to supervise an institution effectively, they need to know what business that institution is conducting and how the institution is conducting it. Increasing numbers of banks are expanding their operations across borders. Consequently, supervisors no longer have the same kind of access to the full range of such banks' books or the information on their operations that they had in a simpler time when banks confined their activities to domestic operations. The principle of consolidated supervision is widely accepted as the appropriate standard by which to supervise banks that operate internationally. Both the home and host jurisdictions are reassured by the fact that some supervisor is looking to see that such institutions are operating both safely and soundly and in conformance with the law. Consolidated supervision depends, to a large extent, on good information about the financial condition and activities of these institutions.

How does the home country supervisor effectively supervise when a bank operates in many countries around the world? There are many different ways. One way is that home country supervisors can ask for and receive information directly from the bank. Home country supervisors can ask for information on the bank's operations and the operations of its subsidiaries or its affiliates regardless of where they are located. In the United States, supervision is based on on-site examination. U.S. examiners may go to other countries and actually look at the books and records of a branch or a subsidiary operating in that jurisdiction.

There are, however, impediments to getting information either directly from the bank or through on-site visits because local laws may impose

restrictions on the bank regarding the transmission of information to the home country supervisor. Some countries do not allow foreign supervisors to enter and examine local entities, even when the local entity is headquartered in another country or owned by a financial institution in another country. Moreover, serious impediments to effective supervision arise from bank secrecy legislation. Some jurisdictions seek to attract business precisely on the basis that they can afford high protection for customer information, and customers may feel very confident about placing their money or investments in those jurisdictions because of the bank secrecy requirements.

U.S. supervisors think that these kinds of local impediments, especially bank secrecy requirements, should not be allowed to interfere with effective, consolidated supervision on a worldwide basis. Such impediments create serious safety and soundness problems if the home country supervisor is not able to obtain information on the foreign operations of its own institutions. They also raise the possibility that certain institutions might use those local secrecy laws not for legitimate reasons of customer confidentiality, but for illegitimate reasons, for example, to hide the criminal activities of customers. Any customer that is acting in a criminal capacity has no legitimate right to expect confidentiality. The U.S. supervisors view these kinds of impediments to the sharing of information as serious issues that should be addressed—whether the impediment is between the institution and the home country supervisor, concerns the home country supervisor's ability to conduct examinations on-site, or derives from a restriction in the local law preventing the local supervisor from sharing information with the home country supervisor. These impediments are under discussion in the Basle Committee on Banking Supervision. Supervisors are trying to understand and deal with the practical aspects of these problems—how to ensure that they are able to exercise consolidated supervision when local law may give rise to these kinds of restrictions.

Host Country Supervisor's Perspective

The second aspect of why it is important that supervisors be able to share information among themselves is from the perspective of host country supervisors. In the United States, there are hundreds of foreign banks from over 60 countries. U.S. supervisors do not have the same kind of responsibility with respect to those foreign banks as with U.S. banks. However, U.S. supervisors do have certain expectations about such banks. It is expected that they be supervised properly, adhere to prudential standards, and operate safely and soundly. There should be a home country supervisor looking after each bank to make sure it is adhering to

those standards and that it is operating in conformance with the law. The U.S. interest as a supervisor of foreign banks' branches or subsidiaries located in this country is obvious—they are participants in the U.S. market. Although the U.S. supervisors do not bear responsibility for the consolidated organization, they want to make sure that the participation of such banks in the U.S. market does not affect U.S. customers adversely or have an effect on the U.S. system that might weaken it or create other systemic problems. Consequently, U.S. supervisors have an obvious interest in monitoring their liquidity.

The issues may be different when comparing the entry of a foreign financial institution against its continuing operation in the United States. Once the entity is established, it is especially important for the U.S. supervisors to have good lines of communication with the home country authorities because the U.S. supervisors are only seeing a small part of the entity and could be unaware of larger events that are shaping the destiny of a particular bank. The Barings case is an example of this phenomenon. There were various subsidiaries of Barings operating in different markets, although there did seem to be a true awareness on the part of various local supervisors in Asia that something strange was occurring. The home country authorities in the U.K. apparently were not aware that there was something unusual occurring in the various foreign subsidiaries of Barings. If there had been some kind of agreement, arrangement, or contact, it might have been easier for the authorities in Singapore or Japan to pick up the phone and ask the appropriate authorities in the United Kingdom, "Do you know what is going on? Are you aware of the positions that are being built up in this subsidiary?" Such queries could have caused the U.K. authorities to deal with the head office and determine what was occurring. In these circumstances, the outcome may possibly have been different.[1] In summary, there is a need for good lines of communication once an entity is open and operating in one's market.

In the United States, after the failure of the Bank of Credit and Commerce International (BCCI), the U.S. Congress decided that the real difficulty with BCCI was that no one was looking after the whole organization. Consequently, a statute was adopted that provides that no foreign bank can enter the United States to conduct banking operations unless it is subject to comprehensive consolidated supervision by home country authorities.[2] Another provision of that statute is a requirement that before the Board of Governors of the Federal Reserve System can approve an application by a foreign bank to open an office or subsidiary in the United States, the Federal Reserve must obtain adequate assurances from the foreign bank that it will provide whatever information is deemed necessary to be able to determine compliance with U.S. law.[3] That provision was put in the law specifically because of the collapse of BCCI.

In implementing this provision, the United States recognizes that there are legitimate home country interests in protecting certain kinds of information. The United States does not want to have an absolute requirement that an organization agree to violate its home country laws before it enters the U.S. market. If, for example, local law prohibits the sharing of information without obtaining the consent of a customer, the Federal Reserve requires the bank to agree to try to obtain the consent of the customer. If there are other kinds of restrictions in local law, the bank is asked to agree to use its best efforts to cooperate in getting those restrictions lifted. Finally, the Federal Reserve usually imposes a condition in its approvals of foreign bank applications that if, in fact, in the future, a foreign bank does not provide it with information that is believed to be necessary for the administration of the law, then the Federal Reserve may terminate the U.S. presence of that foreign bank because it cannot keep its commitment.

When acting on a foreign bank's application to come into the United States, the Federal Reserve also takes into account whether the home country supervisor is able and willing to share information with it concerning that particular bank. In assessing a foreign bank's application, U.S. supervisors have found it helpful to be able to look to the home country supervisor and know that, even if there are local laws restricting the bank from sharing information, the home country supervisor is statutorily permitted to share information with host country supervisors. Then, if questions arise as to the nature of a bank's operations or if in a case such as BCCI there are questions of criminal activity or unsafe practices, the U.S. supervisor can turn to the home country supervisor for information. The host country supervisor is not interested in exercising consolidated supervision over the foreign bank. Rather it is interested in knowing that the home country exercises consolidated supervision and that there are open lines of communication with the home country authorities if information about that applicant is needed.

Cross-Industry Sharing of Information

In today's increasingly integrated world, there is considerable consolidation among organizations across industry lines. Consequently, there is a need for supervisors to work together when there are various types of financial institutions within a group. Initiatives are under way with the Basle Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO) to facilitate sharing of information between bank supervisors and securities regulators. There is also work under way in the Joint Forum, a group established jointly by the Basle Committee, IOSCO, and the International Association of Insurance Commissioners.

What happens in the international supervisory area when securities and/or insurance activities are combined with banking activities in the same corporate group? The standard of consolidated supervision is only accepted currently in the area of banking. No other financial services industry, such as securities or insurance, has agreed to that principle or has recognized the need for a consolidated home country supervisor, for example, for a securities firm operating cross border or for an insurance company operating cross border. Perhaps that is because the problems associated with those two types of companies are not quite as apparent as the problems that arise when a bank operating cross border fails. Also, in the United States there is still a segmentation of the various financial services industries. Full-service securities organizations have difficulty buying banks, banks have difficulty in affiliating with large investment houses, and banks and their owners—bank holding companies—are generally prohibited from affiliating with insurance companies.

While U.S. supervisors have not confronted this problem, in many countries local laws do not segment the financial services industries at all. It is common for banks to own securities companies or insurance companies, and a holding company may have securities, banking, and insurance subsidiaries. Moreover, because of the changes in the financial services industries, it is increasingly difficult to tell a banking product from a capital markets product or an insurance product. Financial organizations tend to act together to cross market their products in order to offer enhancements in these products. A bank may offer credit enhancement of a capital markets product or on an insurance product, and therefore the fate of a bank in one of these groups could become tied to whether or not the group's securities or insurance company is prudently supervised. While this has not been a problem domestically for the U.S. bank supervisors, there are U.S. financial groups that operate in foreign countries in all three of these areas. For example, large U.S. investment houses, such as Merrill Lynch or Goldman Sachs, are not regulated as banking organizations in the United States, but they may own bank subsidiaries in other countries.

The issues faced by the regulators of these financial companies are becoming more serious. Multilateral initiatives have been undertaken to try to come up with practical ways that information can be shared across industry lines. This will likely be a greater challenge than it has been in banking. For more than twenty years, bank supervisors have recognized the need to talk with each other. Securities regulators in the past fifteen years through the IOSCO have recognized the need to get together. The International Association of Insurance Commissioners provides a forum for insurance regulators to talk with each other. However, all three of the groups now need to get together and determine how they can help one

another. Their common aim is to make sure that the various parts of a financial conglomerate do not create problems for the group as a whole. In this endeavor, policy issues, legal issues, and practical issues will need to be resolved.

Afterword to Chapters 10 and 11

WILLIAM BLAIR

Chapters 10 and 11 stress a number of trends in banking. Some of these trends—globalization, increasing diversification, and the impact of technology—have been evident for quite some time. They imply a changing view of the content of risk. There is nothing new in risk. Banks have always been in the business of risk management. The issue is one of ensuring that new risks are properly identified and properly managed. Systems of supervision need to respond to the changes within the boundaries of what is achievable and desirable. Nevertheless, risk has now taken center stage. A major underlying factor has undoubtedly been the explosive growth in the trading of derivatives and the part played in it by banks. The implications of this development are not debated here. However, the concomitant risks are and have to be in the forefront of the minds of supervisors throughout the world.[1]

The trends also imply that bank supervision can no longer be regarded as a purely domestic activity. Bank supervision has an international dimension, more or less important according to the nature of the bank or business concerned. There can be no question that exchange of information between supervisors is assuming ever-greater importance. As long ago as 1990, the Basle Committee on Banking Supervision was urging cooperation between supervisors,[2] and moves in this direction are proceeding apace. However, a number of important policy issues arise, some of which are mentioned subsequently.

The following is a summation of the main points of Chapters 10A and 10B and Chapter 11. First, Chapter 10A describes the supervision-by-risk program introduced by the Office of the Comptroller of the Currency (OCC), which is the primary regulator of nationally chartered banks in the United States. It was described as an evolution rather than a revolution in supervisory practices. It is not a substitute for CAMEL.[3] The program is notable among other things for the classification of risks for bank supervision into nine categories: credit, liquidity, interest rate, price, foreign exchange, transaction, compliance, strategic, and reputation risk. It is obvious that some of these categories are more difficult to measure than others. Nevertheless, it is right to recognize "reputation risk" as a separate category, despite difficulties in quantifying it. Ultimately, a bank's survival depends on its reputation and the confidence that its reputation engenders in depositors.

It remains to be seen how this program will work in practice. In the long term, it is likely to be influential internationally. For example, the

Bank of England announced that it will introduce a more systematic approach to risk assessment. The OCC's evolutionary approach is also evident in the regulation of bank capital, where the U.S. authorities counseled that a bank's own model may often be relied on. The Basle Committee adopted a models-based approach for determining capital requirements to cover market risk on securities and derivatives. Banks are permitted to use their own models to calculate market risk, subject to certain specified parameters.[4]

Second, the supervision of the branches of foreign banks inevitably presents particular challenges. Chapter 10B describes the supervision program used by U.S. bank supervisory agencies, including the Board of Governors of the Federal Reserve System, for the supervision of the U.S. operations of foreign banking organizations (FBOs) in the United States. He pointed out that, although there was nothing radically new about this program (which was adopted in 1995), what was significant about it was the level of coordination among the agencies involved. He described the key features of the program, including the system that emphasizes risk management, operational controls, compliance, and asset quality (ROCA) and replaces the previous rating, which focused heavily on the condition of the branch or agency's portfolio of risk assets at a particular point in time. Again, the emphasis is on risk identification and management.

Non-U.S. observers must bear in mind the unique structure of the U.S. regulatory system. A number of factors have contributed to the structure.[5] The historic separation of banking and securities business and the restrictions on interstate banking have no real counterpart in Europe. These factors, and the sheer size of the U.S. economy, have resulted in a more complex supervisory framework than exists elsewhere that is characterized by a number of different agencies, each responsible for different parts of the banking system.

Third, Chapter 11 describes the increased urgency for supervisors of financial institutions to assist one another in understanding the risks undertaken by internationally active banks and to cooperate in sharing information on those aspects of the bank's business relevant to each supervisor. The U.S. laws dealing with the collection and disclosure of confidential financial information were addressed. There is an important issue here, namely the balancing of the desirability of the exchange of information between supervisors with the right to privacy of the supervised institutions and their customers. So far as foreign banking supervisors are concerned, the Federal Reserve Board is authorized to share information subject to certain safeguards, including confidentiality. The Board has for some time been working to develop a form of agreement that can be used as the basis for sharing information with foreign authorities in supervising cross-border operations. The point was made (which

is sometimes overlooked) that there can on occasion be a downside in disclosing information unnecessarily. Disclosure may, for example, weaken a troubled institution further. In some cases, it may be necessary to balance the competing interests of sharing on the one hand and maintaining market confidence in the particular banking organization on the other.

In Chapter 11, a compelling case is made for a model agreement governing the exchange of information. The Barings case has demonstrated how vital such an exchange can be. However, to whom is information to be disclosed? Under what circumstances? With what safeguards? These are sensitive issues that require proper analysis and, if possible, international consensus.

Before leaving this topic, it is worth mentioning that legal bars on the dissemination of banking information fall into two distinct categories. First, there are the so-called bank secrecy laws. Most jurisdictions have them in one form or another. These laws apply to the relationship between the bank and its customer. They reflect the fact that a customer is entitled to have his financial affairs kept confidential and impose upon a bank a legal obligation to do so. Second, in a different category, there are legal rules that restrict the disclosure of information about financial institutions obtained by supervisors in the conduct of their supervisory duties. These prohibitions are typically contained in statute or similar law and create duties between the financial institution and the supervisory authority. In Europe, for example, Article 12 of the First Banking Directive imposes prohibitions on the divulging of confidential information.[6] Pursuant to Article 12(2), member states may conclude cooperation agreements providing for exchanges of information with the competent authorities of third countries only if the information disclosed is subject to guarantees of professional secrecy.[7] A proposal to extend this provision to the nonbanking supervisory authorities of third countries is under consideration. It is into this second category that most of the legal ramifications of information exchange fall.

The Barings case, which received attention in these pages, is a classic example of the consequences of a failure of internal control. The U.K. Board of Banking Supervision, which produced a report on the affair,[8] made internal controls the primary focus of attention.[9] The report also indicated a number of lessons to be drawn by the Bank of England as supervisor. However, notably, nothing in the affair has diminished the Bank of England's reputation as a supervisor.[10]

In brief, the Board recommended:

- that the Bank should explore ways of increasing its understanding of the nonbanking businesses (particularly financial services businesses)

undertaken by those banking groups for which it is responsible for consolidated supervision and how those businesses interrelate to one another and to such groups' banking businesses. It should also seek to obtain a more comprehensive understanding of how the risks in those businesses are controlled by the management of the group;

- further safeguards in relation to the solo consolidation[11] of any active trading entity with the Bank;
- close collaboration between the Bank and other regulators both in the United Kingdom and overseas;
- that the Bank should treat the audit committee and the internal audit function as a valuable source of information. It would not be realistic to review all internal audit reports as a matter of course, but there should be an opportunity to discuss internal audit, control, and related issues;
- that effective use should be made of reporting accountants;
- that repeated or significant breaches of large exposures rules demanded prompt investigation;
- that regulators should be aware of guarantees and comfort letters given by banks in respect of the obligations of other group members. While a guarantee is a legally binding obligation, the status and effect of a comfort letter is not always as clear; such letters can range from virtual guarantees to mere statements of awareness (although letters falling within the latter category should not be disregarded because they may pose a risk to the reputation of the bank issuing them); and
- that supervisors should be subject to an independent quality-assurance group review of the supervision of banks.[12]

The Board also considered the desirability of increasing the level of on-site visits to bring the United Kingdom more in line with U.S. practice. It concluded that a wholesale change to the existing style of supervision was not justified. As a follow-up to the report, in October 1995 Arthur Andersen was appointed to review the effectiveness of the operation of the Bank's Supervision and Surveillance Division. The Bank has now indicated that the various recommendations that came out of these reports will be implemented.[13] The result will be the most far-reaching reorganization of the bank's supervisory function in many years. Key elements include:

- clarifying the standards and processes of supervision and how these are linked to the overall objectives of supervision to ensure appropriate

internal focus and to promote better understanding among the banks and the public at large;

- developing a more systematic model of risk assessment, which will then drive the supervisory program in respect of individual banks. A version of that model[14] has already been prepared and tested successfully, but further modifications will be needed as it is applied throughout the banking sector; and
- a reorganization of the Supervision and Surveillance Division into a larger number of line divisions, and the creation of an Operations Division to encompass training and other support functions.

As always, such changes carry a financial cost. An increase of staff in the Supervision and Surveillance Division from current levels of about 385 to about 486 is envisaged. The proposals imply roughly a 20 percent to 25 percent increase in total costs attributed to supervision, or £7–8 million on the current total of £35 million. However, the Bank has made it clear that there will be no radical change in its style of supervision (for example, toward the laissez-faire approach being adopted in New Zealand,[15] or toward a more rule-based or inspection-based approach to supervision).

Chapter

12 Resolution of Sovereign Liquidity Crises: Basic Concepts and Issues

FRANÇOIS P. GIANVITI

The expression "sovereign liquidity crisis" refers to a situation where a government is unable to service the country's debt. Usually, and more specifically, the debt that cannot be serviced is the country's external debt, which raises questions of applicable law because a country's debt to its foreign creditors may be governed by foreign law or international law.

The term "sovereign" emphasizes the fact that the debtor is a sovereign state, a subject of international law, and, therefore, cannot be subjected to bankruptcy procedures or other normal legal remedies because of its sovereign immunities. The only remedies will be those that can be negotiated between the sovereign debtor and its creditors. Whether this situation should be changed and how is addressed in other chapters. At this stage, the elements of the problem need to be identified.

To that end, this chapter examines the main issues under three headings:

- the concept of sovereign debtor;
- the concept of liquidity crisis; and
- the concept of external debt.

The Concept of Sovereign Debtor

A distinction must be made between three categories of debtors: private debtors, official debtors other than sovereign states, and sovereign debtors.

Private Debtors

When a private debtor fails to pay his creditors, the creditors may have recourse to various remedies. They may resort to bilateral or collective procedures. The procedure is bilateral if a creditor acting individually sues the debtor to collect his claim. The procedure is collective if the creditors acting together sue the debtor to collect their claims.

A collective procedure may be initiated by the creditors; in that case, it may end either by a collective disposition of the debtor's assets or by a

negotiated agreement between the creditors and the debtor (a *concordat*). In most countries, however, collective procedures may be initiated by the debtor or by a single creditor filing a petition with the competent court. The filing of the petition suspends all individual proceedings against the debtor, and each creditor must then submit his claim to the court.

Depending on the seriousness of the debtor's situation, two resolutions are possible: reorganization or bankruptcy. The debtor's activities can be reorganized, probably with some concessions from the creditors (such as grace periods, longer maturities, lower interest rates, or partial debt forgiveness). In that case, the debtor will be allowed to resume activities within the terms of the reorganization plan (which may include the sale of assets, a reduction of work force, or additional financing) approved by the court. If no viable solution can be found, however, a bankruptcy must be declared. In that case, the assets will be sold; the proceeds will be distributed first among secured and other preferred creditors according to their rank, and the balance will be shared among other creditors *pari passu* (in proportion to their claims).

Official Debtors (Other than Sovereign States)

Most countries do not allow creditors to seize the assets of their public entities. These assets belong to the nation and must remain available for the service of the nation. However, nothing would prevent a city or other public entity from renegotiating its debt with its creditors, along the lines of a *concordat* between private parties. In the United States, the federal U.S. Bankruptcy Code goes even further by allowing insolvent municipalities to file petitions with the courts for the adjustment of their debts.[1] However, under U.S. law, as under the laws of certain other countries, there is no bankruptcy procedure in the usual sense for municipalities. Moreover, creditors cannot ordinarily attach the assets of municipalities (unless the reorganization or "debt adjustment" plan so provides). The U.S. procedure for reorganization of municipalities cannot be initiated by creditors.[2]

Sovereign Debtors

A state is a legal entity. It may own assets and incur liabilities. The terms "state" and "country" are often used interchangeably, but the term "country" may also be used more loosely to refer to all the economic agents, public or private, within the country.[3] For instance, a country's balance of payments includes all claims and liabilities not only of the state but also of all the residents vis-à-vis nonresidents.

In this discussion of sovereign liquidity crises, the term "country" is used as a synonym for "state," but that narrow definition may be somewhat misleading for three reasons.

First, the state may have guaranteed the debts of other official and perhaps even private entities. For instance, a state-owned railroad company may have borrowed with the guarantee of the state. This contingent liability is undoubtedly included in the concept of sovereign debt.

Second, even if the state has not guaranteed the debts of its official entities, it is hardly conceivable that the state will not come to the rescue of such entities if they are unable to service their debt (for example, the case of a nationalized bank, Crédit Lyonnais, in France or the cases of several state-owned airlines).

Third, the major problem for sovereign debtors is the service of their external debt because it is usually payable in foreign currencies. The lack of foreign exchange in a given country will affect not only the service of official debt but also payments by private debtors. Scarce foreign exchange will have to be allocated by the government or the central bank, which will result in arrears on private debt because of exchange restrictions. Therefore, at this point, the distinction is not so much between official and private debt, but rather between debt payable in local currency (usually internal debt) and debt payable in foreign currency (usually external debt).

Notwithstanding these objections, the concept of sovereign debt is rather clear: it includes both direct and contingent liabilities (guarantees) of the state. A sovereign debt, like other official debt, cannot give rise to the usual remedies available for private debt. A state's assets cannot be seized within its territory, and they are protected abroad to a large extent by the laws on sovereign immunities of foreign states.

The Concept of Liquidity Crisis

Liquidity Versus Solvency

A distinction must be made between liquidity crises and insolvency. A debtor who has to make a payment on a certain date needs liquid assets to make that payment. The fact that the debtor owns land or buildings or has a claim on a third party is not sufficient unless the creditor is willing to accept these assets in payment. In other words, a debtor may be perfectly solvent while being unable to pay his debt. Solvency does not, therefore, equate with liquidity. Reciprocally, a debtor may continue to pay his debt while insolvent, because he has enough liquid assets to pay

the debts as they become due, but it is only a temporary liquidity because eventually the debtor will not have enough assets to pay all his creditors.

For a private debtor, liquidity is essential to avoid the initiation of a bankruptcy procedure by his creditors, but solvency may be taken into account in a reorganization procedure because the creditors may have the assurance that, given time, they will be paid the full extent of their claims.

Liquidity and Solvency of Sovereign Debtors

A state may be short of liquid assets but, as bankers have often contended, a state is never insolvent. The reason is that a government's inability to pay should be temporary. Obviously, not only can a state borrow like any other debtor to refinance its debt, but it can also adopt fiscal measures, such as reductions in expenditure and levying of higher taxes, to generate additional resources with which to pay its creditors. The fact that fiscal measures may require the approval of the legislature is not an excuse for defaulting on official debt: the legislature is an organ of the state and needs to take whatever decisions are necessary to enable the state to pay its debt. In practice, however, things are not so simple.

First, fiscal measures are usually unpopular. Cuts in expenditure will reduce appropriations for public services and subsidies for basic commodities: health, education, transportation, and food will become more expensive or will no longer be provided as before. Higher taxes will also reduce the standard of living. Even if the government and the legislature have the political courage to adopt an austerity program, there may be strikes, riots, or even insurrections, and a new government or a new legislature may come to power and repeal those unpopular measures.

Second, as an alternative or a complement to an austerity program, the government may resort to inflationary policies through the central bank. Credits to the government will facilitate the service of the debt, and inflation—if it is contained within limits—will raise tax revenue, thus alleviating the fiscal burden of the debt. However, inflation also raises the cost of operating governmental activities and, because there is a delay between the incurrence of additional cost and the receipt of tax revenue, there may be a situation where inflation is counterproductive.

Third, a particular problem arises if the sovereign debt has to be paid in foreign exchange. Even if the government has generated fiscal revenue, it still has to find the necessary foreign exchange. If foreign exchange cannot be borrowed (and lenders in difficult times tend to become scarce), it has to be bought. Inflation will have raised the cost of foreign exchange, which requires additional fiscal measures to finance the additional cost. Moreover, there may not be enough foreign exchange in the

central bank and the banking system to service the country's debt while maintaining the level of imports. Exchange restrictions may have to be imposed. In addition, monetary policies will be needed to attract foreign capital and to reduce consumption in order to generate exports; this means less credit to the public and private sectors, and higher interest rates. A depreciation of the exchange rate will have similar effects by making local goods and investments less expensive and foreign goods and investments more expensive, but a depreciation will also increase the local currency cost of foreign exchange for the service of the country's external debt.

At this point, it is necessary to distinguish debt payable in local currency from debt payable in foreign currency. A distinction between external and internal debt is often made on this basis, but the reality is more complex.

The Concept of External Debt

Distinction Between External and Internal Debt

In balance of payments terminology, an external debt is a debt of a resident to a nonresident. In many cases, the nonresident creditor will not accept a payment in the debtor's currency, for instance, when that currency is not freely convertible, is expected to depreciate, or is not generally accepted in international transactions. The creditor may want to be paid in his own currency or a third currency. For example, a Mexican exporter to India may want to be paid in U.S. dollars. Therefore, it is tempting to equate the two concepts of external debt and debt payable in foreign currency (that is, a currency other than the debtor's).

Conversely, an internal debt is a debt between two residents. Usually, the debt will be payable in local currency because the resident payee will use the proceeds within the country of payment. Sometimes, the local law will even require that the payment be made in local currency, which is an exchange control measure but not a restriction. Even if payment in local currency is not mandatory, the stipulation of payment in foreign currency may be invalid as a violation of the legal tender character of the local currency.

While recognizing all these reasons for contrasting external debt and internal debt, it must be said that the residence of the parties and the currency of payment are not necessarily linked. It often happens that a resident debtor and a nonresident creditor will enter into a contract payable in the debtor's currency, particularly if that currency is generally accept-

ed in international transactions. That currency may even be unstable: the creditor will only have to insert a maintenance of value clause to avoid an exchange rate loss. The same is true of sovereign debtors. For instance, many industrial countries issue bonds denominated and payable in their own currencies, and those bonds are often bought by nonresidents. These bonds constitute an external debt of the issuing government, although they are not payable in a foreign currency. For instance, the Mexican tesobonos, which were largely at the source of the last Mexican liquidity crisis, were payable in Mexican pesos. Reciprocally, two residents may—if it is permitted by their local law—enter into a contract payable in foreign exchange.

Therefore, the distinction between external debt and internal debt is not based on the currency of payment and does not necessarily correspond to a difference between payment in local currency and payment in foreign currency. These two criteria (residence and currency of payment) are not interchangeable. Their relevance must be assessed separately.

Relevance of the Two Criteria

Residence of the Parties

External debt as such raises specific problems in that it is usually governed by foreign law or international law. Moreover, the nonpayment of foreign creditors by a sovereign debtor may give rise to representations by the creditors' government in the exercise of its diplomatic protection of their interests. Undoubtedly, a government's default on its internal debt does not raise the same concerns.

However, from another standpoint, external and internal debt may have to be addressed together. The fiscal measures required to restore the sovereign debtor's liquidity will have to take into account its internal indebtedness, and the question will arise whether the government should give preference in the service of its debt to foreign creditors over local creditors or vice versa.

Another difficulty that cannot be ignored is that the residence of the creditors may change or be unknown. This is particularly true of bondholders who may be anonymous, Are they residents or nonresidents? The question arose in the context of the Mexican tesobonos, but no distinction was made between residents and nonresidents in the service of the debt.

Currency of Payment

A shortage of local currency is easier to remedy for a government than a shortage of foreign exchange. This truism may explain why so much

attention is usually given to the currency of payment in discussions on sovereign external debt.

However, this distinction does not make much sense when the local currency is freely convertible. In such cases, even resident creditors receiving their payments in local currency are free to convert them into foreign exchange and invest the proceeds abroad. The confusion is even greater when the sovereign debtor guarantees both the convertibility and the exchange rate, in order to shelter the creditors from an exchange rate depreciation. This was the case with the Mexican tesobonos, where the problem was treated in fact as part of the country's external debt, regardless of both the residence of the creditors and the currency of payment.

Conclusion

The resolution of sovereign liquidity crises involves a number of different, and sometimes conflicting, considerations. Clearly, greater attention has been given to foreign creditors and to the problem created by the shortage of foreign exchange. However, the problem cannot be resolved by ignoring the situation of local creditors and the impact of local currency payments both on the budget of the sovereign debtor (putting aside the situation where its currency is convertible) and on the availability of foreign exchange for all creditors, foreign or local.

Chapter

13 Legal Framework for Dealing with Sovereign Debt Defaults

HERBERT V. MORAIS

Introduction

The Mexican financial crisis in December 1994 was a wakeup call to the international financial and political community to urgently consider improved procedures to deal with sovereign liquidity crises. The increasing size and diversity of financial flows to the emerging market economies, the growing liberalization of capital markets, and the revolution in information technology have made it clear that countries are much more susceptible to sudden and large shifts in their foreign reserves positions.

It took "all the King's horses and all the King's men" to rescue Mexico from its financial crisis. The International Monetary Fund (IMF), for its part, provided the largest financial assistance package in its history—totaling about $17.8 billion equivalent—under an emergency Stand-By Arrangement. In addition, the United States provided about $20 billion, and the Bank for International Settlements offered about $10 billion to Mexico. If there ever was a balance of payments crisis, this was it. The quick provision of this temporary financial lifeline to Mexico contributed significantly to averting an even bigger crisis worldwide and served to restore investor confidence in the Mexican economy.

Mexico has taught a couple of important lessons that national treasuries and central banks need to carefully study and benefit from. The first lesson is that the world simply cannot afford to face repeated sovereign liquidity crises of the magnitude of Mexico. The second lesson is that, if such crises were to occur again in spite of the best preventive measures, including strengthened surveillance by the IMF and better provision of information on economic and financial data to the public by member countries, both the IMF and the international financial community must be ready to respond effectively.

Therefore, treasury officials, central bankers, and lawyers have a formidable challenge to urgently examine the inadequacies of the present legal framework for dealing with sovereign liquidity crises and to come up with new ideas and improvements in legal procedures for resolving such crises in a comprehensive and meaningful way.

Traditional Legal Framework for Dealing with Sovereign Debt Problems

To be able to consider and propose improvements in legal procedures for dealing with sovereign debt problems in the future, it is necessary to first identify and analyze the deficiencies in the existing "traditional" legal framework for rescheduling sovereign debt. There are several different categories of sovereign debt. The main categories of such debt are financial assistance from multilateral financial institutions like the IMF, the World Bank, and the regional development banks; credits from official bilateral sources (including export credit agencies); syndicated loans from private financial institutions (mainly commercial banks); and bonds publicly issued by sovereign borrowers in the international capital markets.[1]

The legal framework governing each of the main categories of sovereign debt is addressed below, including essential features, contractual provisions, and overall adequacy and effectiveness.

Multilateral Credits

The first category of debt is that owed to multilateral financial institutions (MFIs), such as the IMF, the World Bank, and the regional development banks. Debt owed to MFIs has consistently been excluded from debt reschedulings because these institutions are considered "preferred creditors." Moreover, member countries, as a practice, give higher priority to servicing their multilateral debt over other external debts when faced with a shortage of foreign currency. This preferred creditor status is not based on any contractual provisions in the relevant loan or other financing agreements, but on the unique status of these institutions and their special relationship to their member countries. The policy reasons that underpin their preferred creditor status include the following: first, these institutions make loans in circumstances under which other lenders would not participate; and, second, a reduction in the value of debt to such institutions affects all members, including the debtor. Furthermore, in the case of the World Bank the policy against rescheduling is designed to protect its triple-A credit rating in the international bond markets, from which it draws most of its loanable resources and where it is one of the largest borrowers.

Bilateral Credits

The bulk of official bilateral credits to sovereign borrowers in the Third World is provided by the governments of the major industrial countries that constitute the Organization for Economic Cooperation and

Development (OECD). When a sovereign borrower anticipates default in the service of its debt to these official creditors, it usually contacts the Paris Club. The Paris Club is not a formal legal entity or international organization. Rather, it is an informally organized group of official creditors that has operated for many years under the chairmanship of a member of the French Finance Ministry.

The Paris Club first met in 1956 specifically to deal with Argentina's difficulties in servicing its debt to several European sovereign creditors. It has continued since that time as a forum for handling the restructuring of official bilateral credits and guarantees extended by OECD countries. For each sovereign borrower, the Paris Club negotiations conclude with an Agreed Minute, setting forth a uniform formula on the basis of which each creditor will renegotiate directly with the borrower. This formula does not constitute the restructuring; rather, it provides the broad legal framework or principles to be followed in negotiating subsequent bilateral restructuring agreements. A fixed period (for example, 12–18 months) is allowed for renegotiation. While not constituting a formal, contractual standstill, it is generally understood that a creditor will not press its claims during this period.[2] The borrower, in turn, gives the Paris Club creditors an undertaking that non-Paris Club creditors would receive "comparable treatment," although the precise meaning of this term has never been fully understood. The IMF, the World Bank, the OECD, and the European Union are invited as observers to Paris Club meetings. It is important to note in this context that the existence of an economic adjustment program supported by the IMF is a precondition for restructuring agreements concluded under the framework of the Paris Club. In turn, reaching agreement with the Paris Club is also usually a precondition for London Club reschedulings with the commercial banks. Similarly, the existence of arrears to Paris Club creditors would normally disqualify a country from access to IMF resources.

The terms of Paris Club reschedulings have varied from time to time. They have ranged from straightforward postponement of maturities to interest rate reductions and, in more recent years, have gone as far as providing partial debt forgiveness or cancellation. Under the latest terms, known as the Naples Terms and adopted in December 1994, low-income rescheduling countries are eligible to receive a reduction in eligible official bilateral debt ranging from 50 percent to 67 percent in net present value (NPV) terms.

On the whole, Paris Club reschedulings have been efficient and satisfactory and have provided significant debt relief to many countries, particularly those less-creditworthy countries in Africa that rely more heavily on official sources of credit. The only remaining problem with respect to

official bilateral credits is that several major bilateral creditors (such as Russia and countries in the Middle East, like Saudi Arabia and Kuwait) do not operate within the framework of the Paris Club. It would, therefore, be more difficult to coordinate the inclusion and participation of non-Paris Club creditors within the framework of any comprehensive debt adjustment procedure for sovereign debtors.

Syndicated Loans

Financing under syndicated loans is generally provided by financial institutions, mainly private commercial banks but also including investment banks and insurance companies. Since the early 1970s when banks were awash with petro dollars, syndicated bank lending has been the principal source of financing for sovereign borrowers, although there has been a significant decline in recent years. For the most part, the loans are provided by foreign or nonresident financial institutions.

The term "syndication" signifies that a number of financial institutions agree to jointly provide the loan to the sovereign borrower under one loan agreement. On the other hand, a curious feature of loan syndications is that lenders also reserve the right to take independent action under certain circumstances, such as the right to institute legal proceedings against the debtor. The result has been the exercise by one or more syndicate members of the right to institute legal proceedings for the recovery of the debt, which has caused problems for some sovereign debtors as they attempted to negotiate and implement rescheduling agreements with a majority of their creditors.

Syndicated loan agreements do not contain any explicit provisions for the rescheduling of the loan under specified circumstances. The usual legal basis for effecting any change in the repayment terms of the loan is the amendment clause included in the loan agreement. This clause ordinarily provides, among other things, that any amendment that seeks to reduce the principal of, or interest on, the loan requires the unanimous consent of the lenders. This requirement of unanimity has delayed the conclusion of several rescheduling negotiations with sovereign debtors.

One of the cardinal principles enshrined in syndicated loan agreements is the equal treatment of creditors. This principle manifests itself in two different ways. First, the principle calls for equal treatment of creditors within the loan syndicate. This principle is given effect through the "sharing of payments" clause, which is found in virtually all loans. The sharing clause provides that, if any bank obtains payment with respect to principal of, or interest on, the loan owed to it that is proportionately greater than the payment obtained by any other bank with respect to such prin-

cipal or interest, then the bank receiving such payment must share such payment with all co-lenders under the agreement on a pro rata basis. This sharing clause is designed to ensure that no one lender is placed, at the discretion of the borrower, in a more favorable position with respect to loan recovery than its co-lenders under the loan agreement. Typically, the pro rata sharing is achieved by an agreement to pool all payments received into the hands of the agent bank, which then distributes the proceeds to all lenders on a pro rata basis. Although the loan agreements generally recognize an individual bank's right to institute legal proceedings against the borrower, the effect of the sharing clause (which stipulates that payments of principal or interest obtained through litigation must be shared pro rata with the other banks) is that there is a strong expectation that even legal proceedings should be instituted jointly because it usually follows an acceleration decision taken by the syndicate.

The second facet of the equal treatment of creditors is designed to achieve intercreditor equality; that is, each lender in the syndicate seeks the assurance of the borrower that it will receive treatment no less favorable than that accorded to other external creditors of the debtor. This principle of intercreditor equality is given effect through four separate but related clauses. These clauses are (i) the pari passu clause, (ii) the negative pledge, (iii) the mandatory prepayment clause, and (iv) the cross-default clause.

The "events of default" clause, which appears in all loan agreements, usually provides that, upon the occurrence and continuance of any of the enumerated events, the lenders may exercise certain legal remedies against the borrower. The single most important event of default is the failure of the borrower to pay principal or interest when due. Such failure is generally considered to be the clearest signal to the lenders that the prospect of repayment of the loan by the borrower is impaired. In the debt crisis scenario, the "failure to pay" event has assumed the greatest significance, as it is invariably the first sign of a borrower's debt servicing difficulties arising from a liquidity squeeze. The other relevant event of default usually included in loan agreements is that the borrower has admitted in writing its inability to pay its debts as they come due or has declared a moratorium. Upon the occurrence and continuance of an event of default, the lenders are entitled, upon notice to the borrower, to terminate the commitment to lend and/or accelerate the maturity of the loan.[3]

The lenders' remedy for default by the borrower following acceleration is to institute legal proceedings against the borrower. Usually, any individual lender may institute legal proceedings in its own name against the borrower, although acceleration decisions normally require a collective decision by a specified majority of the lenders, as noted above. This indi-

vidual right to bring suits has been recognized in numerous judicial decisions in the main lenders' jurisdictions, such as London and New York.

When faced with actual or imminent default by a sovereign borrower, commercial banks have had little difficulty organizing themselves as a representative group to conduct rescheduling negotiations with the borrower. Thus, commercial banks have organized themselves under arrangements known as the London Club (which first met in 1976 to restructure the Democratic Republic of the Congo's debt). This forum has continued to handle the restructuring of loans made by commercial banks to sovereign debtors. Banks that participate in the London Club are represented by a steering committee or advisory committee, which typically consists of no more than 15–20 banks and which deals directly with the sovereign borrower. During the period of negotiation, creditor banks generally refrain from commencing legal proceedings against the defaulting sovereign. The negotiations between the sovereign borrower and the committee are completed when agreement is reached on a term sheet, which outlines the proposed restructuring terms. The term sheet is then sent to all members in the syndicate for their approval. As noted above, syndicated loan agreements usually require the unanimous consent of creditor banks to change the payment terms. This consent has been impossible to achieve in some recent cases, as some banks were dissatisfied with the terms being offered. A few reluctant banks assigned their claims to other parties, which then initiated legal suits against the sovereign debtor.

The typical reschedulings concluded under this framework from about 1982 to 1989 were characterized by four essential features: first, there was maintenance of the full stock of debt; second, the rescheduling essentially involved postponing some of the loan maturities (for example, for two to three years); third, such reschedulings were predicated on the borrower's implementation of an IMF-supported adjustment program; and finally, as noted above, prior agreement on a Paris Club rescheduling was reached.

On the whole, this London Club process has worked reasonably well in the sense that it has succeeded in achieving rescheduling agreements for some of the biggest and most highly indebted middle-income countries like Argentina, Brazil, Chile, Mexico, and Nigeria. When compared with the Paris Club, the London Club negotiation process has been characterized by prolonged delays (sometimes one to two years), friction, and even confrontation. The bargaining positions of the sovereign debtor and bankers have never really been equal, with the bankers usually having the upper hand. Moreover, with the wisdom of hindsight it can now be said that much of the debt relief offered to sovereign debtors was not very meaningful, as evidenced by successive reschedulings. In addition, of

course, there was always a problem with a few banks that refused to go along with the agreed rescheduling terms. These banks have been affectionately called by a number of different names—free riders, rogue creditors, dissenting creditors, and maverick creditors.

A watershed in the sovereign debt crisis was reached when, on March 10, 1989, the then U.S. Treasury Secretary, Nicholas Brady, announced a major new initiative to break the back of the debt problem. Following several years of "muddling through" under the so-called case-by-case approach, the U.S. government (supported by other creditor countries) endorsed debt forgiveness for the first time by encouraging commercial banks to enter into debt and debt service reduction transactions with borrowers that were implementing economic adjustment programs supported by the IMF and the World Bank.

The debt reduction transactions envisaged by the Brady initiative would result in either a reduction of the outstanding principal of the loans (that is, a reduction in the stock of debt) or a reduction in the interest payable on these loans, or both. The sweetener that was suggested under this proposal was that the commercial banks would be offered credit enhancement (funded by the IMF, the World Bank, bilateral sources, and the borrower itself) on the remaining reduced obligations. The three principal instruments that were subsequently used by the commercial banks and some borrowers to implement the Brady initiative were (i) cash buybacks, (ii) discount bonds, and (iii) par bonds.

Under the Brady initiative, several debt and debt service reduction transactions were entered into with the highly indebted countries, particularly the big debtors like Brazil, Chile, Mexico, the Philippines, and Venezuela. The first point to note about these transactions is that, unlike the traditional reschedulings, the Brady debt and debt service reduction transactions provided significant and therefore meaningful debt relief to sovereign borrowers, thereby enabling them to implement their economic adjustment program without an unbearable debt burden. The second point to note is that these transactions have also resulted in a massive transformation of sovereign debt instruments from loans to bonds.

International Bonds

For many years, bonds publicly issued by sovereign debtors in the international capital markets represented only a small component of the external debt stock of most highly indebted middle-income countries. However, the situation changed dramatically in recent years. The total amount of sovereign bonds outstanding has increased from about $20 million in 1980 to about $225 billion in 1993. This was matched by a

significant decline in syndicated bank lending. There are several reasons for this shift, including the gradual drying up of bank loans to sovereign borrowers, the desire of borrowers to broaden and diversify their investor base, and the relative ease with which bonds could be issued.

The most important feature of bonds is that, in contrast to the relative homogeneity of bank lenders under a syndicated loan, the investors in bonds are a very diverse group, ranging from the proverbial Belgian dentist to mutual funds, insurance companies, pension funds, and other institutional investors. The diversity in the investor base seriously complicates any effort toward the rescheduling of the bonds. It is important also to note that, historically, the principal attractiveness of bonds has been that they have generally been excluded from sovereign debt reschedulings, except for a few instances, such as those in Europe between the 1930s and 1950s.

In contrast to the Paris and London Clubs, there is no organized forum for negotiations with bondholders. Therefore, collective representation of, and decision making by, bondholders has been made more difficult by their large number and wide dispersion, and by the proliferation of bearer bonds. However, there are terms and conditions in existing bonds that permit a limited form of organization of bondholders. Currently, representative bond terms and conditions include a trust deed or indenture. The deed normally includes (i) the appointment of a trustee, who manages various aspects of the bond, including implementing certain decisions of bondholders; (ii) clauses providing for the calling of general meetings of bondholders, during which decisions can be made that alter the terms and conditions of the bonds; and (iii) clauses stipulating the quorum required for adoption of changes to the terms and conditions of the bonds. Although the current legal framework does not empower the trustee to serve as agent of the bondholders with regard to negotiating a standstill, a bondholders' meeting called either by the issuer or the trustee could consider resolutions regarding various proposals, including a resolution amending the dates of payment of interest.

With regard to changes in dates of interest payments or any other significant change in the bonds' terms and conditions, representative deeds normally require the consent of all bondholders, not only of those present and voting. Such unanimous consent terms virtually eliminate the ability to restrain "free-rider" bondholders. While the representative trust deeds require unanimous consent, one recent example (an Argentine note issue) provided for majority, rather than unanimous, consent to change such terms and conditions.

Another important point to note is that, unlike syndicated loan agreements, the terms and conditions normally appearing in bonds do not

include a sharing-of-payments clause. The absence of a sharing clause could be seen as offering a perverse incentive to bondholders to commence legal suits against defaulting sovereigns because they would not have to share the proceeds of any judgment with other bondholders. These additional aspects further evidence the lack of cohesiveness and coordination within the investor group and make decision making most difficult.

When reschedulings for sovereign bonds became necessary in the past, especially between the 1930s and the 1950s, the task proved more manageable because the cases were few and far between. A number of ad hoc procedures, such as the establishment of bondholders' committees, were put in place to facilitate negotiations between sovereign bondholders and their creditors; following such negotiations, the bondholders' committees presented their recommendations to the bondholders for approval. Thus, under this framework a standstill was negotiated by a bondholders' committee for Romania's debt in 1933; in 1937, the League of Nations Loans Committee made a similar recommendation in respect of Hungary's debt.

In recent years, there has been a substantial increase in the use of bonds by sovereign borrowers to raise foreign exchange. At the same time, there has been an explosive growth in Brady bonds. This suggests that, in the event of a sovereign liquidity or foreign exchange crisis in the future, it may be impossible to hold bond investors harmless. In these instances, it may be necessary to attempt to arrange a standstill and rescheduling with these creditors as well as those represented in the Paris Club and the London Club.

Two Proposals for Dealing with Future Sovereign Liquidity Crises

Although the Paris Club and the London Club provide reasonably effective forums for restructuring negotiations with official lenders and commercial bank lenders, respectively, there is no such forum for bondholders. Furthermore, there is no single legal framework or tribunal to deal with sovereign debt problems in an orderly and comprehensive way.

A number of proposals have been put forward by scholars and commentators for dealing with these problems. This chapter examines two specific proposals: first, to strengthen the legal framework for negotiating with bondholders; and, second, to establish an international debt adjustment facility patterned to a limited extent on the domestic bankruptcy model.

Strengthening the Legal Framework for Negotiating with Bondholders

Some commentators have suggested that bondholders of sovereign debt could successfully be brought into standstill and rescheduling negotiations by creating a forum representing all or a substantial number of these bondholders, and through which such negotiations could be conducted. A decision by a majority of these bondholders would have to be binding on all bondholders, eliminating the free-rider problem. Three techniques have been mentioned to implement these suggestions:

- encouraging issuers to include appropriate mechanisms in the terms and conditions of each sovereign bond issue;
- requiring the inclusion of such mechanisms by domestic law; and
- establishing bondholders' committees or associations for sovereign bonds through domestic law.

Mechanisms Under the Terms and Conditions of Bonds

The terms and conditions of bonds could provide for (i) the establishment of a bondholders' council (as a forum for negotiation) or the appointment of a bondholders' representative (to represent bondholders during negotiations); (ii) a procedure for bondholder registration (to identify those who have voting rights to approve a standstill negotiated by a representative); and (iii) the binding effect on all bondholders of a decision by a specified majority to prevent free riders from holding up agreement.

As mentioned above, representative bond terms and conditions already have a procedure for calling bondholders' meetings. However, contacting bondholders for the purpose of calling meetings, or perhaps for selecting a group of bondholders to speak informally with a sovereign regarding a standstill or restructuring, may be difficult, especially because most of these bonds are in bearer, and not registered, form. Representative trust deeds do provide for notices of bondholders' meetings to be published in a major newspaper of the jurisdiction where the bonds are listed (often Luxembourg) and the jurisdiction of choice of law and venue (often New York or London). Given the development of modern technology, the notice could be even more widely circulated with little additional cost on the Internet. The addition of such a new term to a trust deed could potentially increase the effectiveness of any notice without materially affecting the bonds' terms and conditions.

Also, as noted above, while representative bond terms require unanimity to effect a standstill or restructuring, there are a few examples of bonds

providing for majority decisions that are binding on dissenting bondholders. It cannot yet be concluded whether the majority rule provisions have had any adverse effect on the cost of capital, but these examples suggest the possibility of including similar, or even more flexible, majority rule provisions in future bond issues. To the extent that such a change makes it appear more likely that a sovereign may default, it could raise the cost of borrowing. However, to the extent that it makes a restructuring more orderly in the event of a default, it could reduce the cost of borrowing. The possibility of extending majority rule provisions in future bond issues could be explored with the relatively small number of major underwriters of such bond issues.

Mechanisms Under the Domestic Laws of Creditor Countries

Many jurisdictions have legal rules that specifically provide for, or otherwise regulate, the organization of bondholders. These may include provisions for bondholder meetings and rules for binding dissenting bondholders through majority votes. These rules are of two types: (i) those that are based primarily in commercial law, which tend to apply to all resident commercial issuers of bonds, and (ii) those that are based primarily in securities law, which apply to bonds that are offered for public sale or market listing in the jurisdiction. The rules based in securities law are unlikely to apply to bonds not offered in the jurisdiction.

Currently, some jurisdictions such as the United States (State of New York) and the United Kingdom have specific provisions in their securities rules only for bonds offered or listed in their jurisdictions, while others, such as France and Germany, do so through commercial laws, which apply to local corporations. Current practice has been not to offer sovereign debt in New York or London, thereby obviating the application of securities laws in these jurisdictions. Because sovereign borrowers are not local corporations, they are not subject to rules governing those corporations.

It is highly unlikely that New York or the United Kingdom would enact laws requiring bondholder councils or majority voting in bonds that are not listed within their territories, or that France or Germany would extend their rules on corporations to sovereign borrowers. Moreover, representative bonds are often listed in Luxembourg, which is also unlikely to change its laws in a way that might adversely affect listings there. Therefore, there is little likelihood that a strategy of requiring specific terms and conditions through national laws would work.

Establishment of Bondholder Associations

Provisions have been made in the past under various domestic laws for the establishment of associations of foreign bondholders. These associa-

tions have played important roles in helping to organize bondholders and in adding prestige and diplomatic authority to negotiations with foreign sovereign borrowers. However, they do not in any way affect the legal status of the terms and conditions of any bond, including the power to call bondholder meetings or for a majority to bind a minority. As these are the principal problems, such associations are unlikely to add materially to any solutions. Until now, there has been no attempt by governments to confer upon these associations the power to consent to changes in the terms and conditions of bonds on behalf of the bondholders.

Adopting the Bankruptcy Approach

One of the most serious problems with current mechanisms and approaches for dealing with sovereign liquidity crises is that there is no single international legal framework or forum that provides for an orderly process of dealing with such crises in a comprehensive manner along the lines of a domestic bankruptcy court. The first aspect of this problem is that there are several different forums (for example, the Paris Club and the London Club), each with its own set of rules, principles, and operating procedures, or no forums (for example, bondholders). The rules of the game are not uniform. The motivations of the Paris Club (politics, economics, aid, security) are quite different from those of the London Club (profit). The second problem is that existing mechanisms fail to deal, or to deal adequately, with certain important categories of debt, for example, bonds and domestic debts, such as Mexican tesobonos. The net result is that the debt restructuring process as it currently exists has some serious shortcomings that need to be corrected.

Various proposals have, from time to time, been put forward for a comprehensive process of debt adjustment at the international level, which would draw on the experience under national laws to the extent relevant or appropriate. Such a process would be based on a sound economic and financial analysis of the country's problems, the formulation of a realistic plan for recovery, and a proper balancing of the interests of the debtor and its creditors in a spirit of cooperation.

In some proposals, reference has been made to Chapters 9 and 11 of the U.S. Bankruptcy Code (U.S. Code). Chapter 11, like the laws of many other countries, allows a debtor or a group of the debtor's creditors to file a petition for reorganization. However, this procedure does not apply to the federal government, states, or other national public entities.

Chapter 9, on the other hand, is more relevant in that it allows a municipality to file a petition for the adjustment of its debts. Chapter 9 differs from Chapter 11 in a number of significant ways: (i) the munici-

pality must be insolvent in order to file a petition; (ii) only the municipality (and not its creditors) may file a petition; (iii) only the municipality may file a plan for the adjustment of its debts; (iv) unless the debtor consents or the plan so provides, the court may not interfere with any of the municipality's political or governmental powers, property, or revenues, or use or enjoyment of any income-producing property; and (v) a Chapter 9 case may not be converted into a liquidation case. Under either Chapter 9 or 11, the legal effect of the filing of a petition is the "automatic stay," or suspension of debt collection and lien enforcement by creditors so that the debtor can continue to operate its business or affairs and prepare a plan without interference or threats of legal action.

Although Chapter 9 and Chapter 11 suggest interesting approaches, the issues raised by the indebtedness of sovereign debtors are too specific to be addressed only by an extension of the principles of these provisions. The mere fact that these provisions do not apply to the federal government or even to the individual states of the United States demonstrates the difficulty of such an extension. However, there may be situations where both sovereign debtors and their creditors would find it advantageous to resort to some type of legally binding debt adjustment procedure under a new international legal framework. On the basis of this assumption, it is proposed to briefly examine the key elements of such a debt adjustment facility for sovereign debtors. The main purpose of this analysis is to draw attention to issues that would need to be settled and difficulties that would need to be overcome before a facility could be established.

Mode of Establishment

Proponents of the bankruptcy approach for dealing with sovereign liquidity crises have put forward a variety of ideas for establishing the facility. Some have proposed that the IMF play a central role in the facility and that it be located within or operate under the aegis of the IMF. The rationale behind this suggestion is that the IMF is the premier international financial institution responsible for monitoring and assisting its member countries with their balance of payments problems, and has the technical expertise and financial resources to discharge this role within the framework of its Articles of Agreement. However, some others have argued that the IMF is not a sufficiently neutral body to handle this task because of its perceived close relationships with its member countries and also because the IMF is itself a major creditor to the debtor countries and may have a conflict of interest problem unless its own claims were excluded (which exclusion, in itself, would generate further controversy). If the IMF were to play a central role, it could do this in one of several ways.

The IMF could establish the facility under Article V, Section 2(b), which authorizes it "to perform financial and technical services," if requested to do so. Thus, for example, the IMF may agree to perform specific financial services or carry out technical services by providing advice, mediation, or good offices. This approach would allow the IMF to assist a sovereign debtor in negotiating an alleviation of its foreign debt service, but only with consenting creditors. However, the free riders would remain free to enforce their claims, which would put the consenting creditors at a disadvantage and might dissuade them from subjecting their claims to the facility. There would still be no mechanism for binding all creditors to a debt adjustment plan agreed to by a majority. Without either a freeze on the right to enforce claims or a mechanism to enforce a negotiated debt adjustment plan among creditors, no orderly procedures for negotiations could be established.

New international treaty obligations could be created, which would, either directly or through specific enactments, become part of the domestic law of participating countries. The principal consequence of this approach is that the facility would apply to all creditors attempting to enforce their claims within the territories of any of the signatory countries. Under this approach, the initial question to consider is whether the task of sovereign debt adjustment could or should be handled by an existing organ, such as the Executive Board of the IMF, or by a separate organ or institution. The task of the facility would be a very technical and specialized one, calling for economic, financial, and legal expertise. It would involve undertaking a detailed analysis of the country's debt problems, resolving disputes with respect to particular categories of debt, and making decisions of a judicial nature. As evidenced by the experience with past sovereign debt reschedulings, this process could be a very time-consuming and complex exercise that would significantly expand the Executive Board's already heavy responsibilities. Moreover, in domestic legal systems debt adjustment procedures are normally administered by courts of law that are independent both of parties and governments. Because Executive Directors are elected or appointed by governments that may themselves be parties (as creditors or debtors) to certain cases, there could be a perception, particularly among private creditors, of a conflict of interest. Therefore, to clothe it with the status of an independent judicial organ, it is important that the facility be established as a separate organ or institution. In this regard, three possible methods may be envisaged:

- Establish a separate organ of the IMF for the specific and limited purpose of facilitating debt adjustment by sovereign debtors through an amendment to the IMF's Articles of Agreement. The organ, which would have a quasi-judicial or arbitral character, would

be managed and operated independently from the IMF's regular operations. The Administrative Tribunal of the IMF provides an example of an independent judicial organ within the IMF.

- Establish an affiliate institution. There are some precedents within the World Bank Group for the establishment of affiliates for specialized purposes, notably the International Centre for Settlement of Investment Disputes (ICSID) and the Multilateral Investment Guarantee Agency (MIGA).
- Establish the facility as a separate international organization under a new international agreement, which all countries would be invited to sign and ratify. This approach, however, could be quite time consuming.

The main difference between the first method and the other two is that an amendment of the Articles would bind all members, while a new treaty would leave individual countries free to participate or not. The former method would avoid the perception that certain countries intended to use the facility as debtors and that others have agreed that their rights as creditors may be impaired while those of other creditor countries would remain unaffected.

Structure and Composition

If a special organ were established within the IMF, the organization would perform the functions of the facility using its staff and resources. If a separate organ of the IMF were to be established, two alternatives may be considered: first, the facility could be established as an independent judicial organ of the IMF, like the Administrative Tribunal. If a separate affiliate or a new international organization were to be established, ICSID and MIGA are possible models. In this case, the facility would be set up as a public international organization whose members would be sovereign states, both debtor states and creditor states (that is, states in their capacity as official creditors or as representatives of private creditors). Like ICSID, the facility should preferably be independent of the multilateral financing institutions and have a lean administrative structure, possibly headed by a secretary-general; and the arbitral organ of the facility should consist of prominent and internationally respected persons with relevant economic, financial, and legal expertise.

Although private creditors cannot become members of public international organizations, their claims may constitute the bulk of external debt owed by a sovereign debtor. A way would have to be found to provide representation to such creditors, possibly through a creditors' committee to serve in an advisory capacity to the facility.

Eligible Debt

For any debt adjustment plan to be viable, all or most of the sovereign debtor's external obligations (including guarantees of other debtors' liabilities) would need to be brought under the purview of the facility. Moreover, consideration would have to be given to the inclusion of domestic liabilities.

A first problem would be the identification of all creditors; difficulties could arise, particularly with respect to the holders of bearer bonds. It would be desirable, therefore, for the facility to establish, with the assistance of the debtor, a registry of all creditors. In addition to the identification of creditors, disputes on the existence and amounts of claims might arise in some cases and would have to be settled.

The second problem would be defining the "eligible debt" that would be subject to adjustment by the facility. The term usually covers the external debt of a government, central bank, or other public sector institutions owed to commercial banks and other private financial institutions (such debt is currently the subject of London Club rescheduling) and to bilateral official creditors (such debt is subject now to Paris Club rescheduling). Debt owed to creditors in the London and Paris Clubs represents a significant portion of the external debt of many highly indebted countries and, as such, should be included in any debt adjustment plan. Such inclusion would not necessarily preclude separate negotiations and conclusion of agreements by these creditors within the framework of a debt adjustment plan established by the facility.

There are, however, a number of other categories of sovereign debt that could raise some problems, depending on their inclusion in, or exclusion from, any debt adjustment process:

- The first category is debt incurred with domestic creditors and denominated either in foreign or local currency.
- The second category is debt owed to secured creditors. Under most national laws, secured creditors are included under a reorganization or debt adjustment plan. However, their claims have priority.
- The third category is debt evidenced by bonds.
- The fourth category is short-term debt.
- The fifth and final category of debt is that owed to multilateral financial institutions such as the IMF, the World Bank, and the regional development banks.

The above-noted problems concerning the definition of eligible debt would need to be resolved at the outset because they are fundamental to the establishment and successful operation of the facility.

Operating Procedures

The following procedures may be considered for the operation of the facility in dealing with sovereign debtors:

Qualification for access to facility. The first question to consider with respect to the initiation of the debt adjustment process is what would be the specific situation that triggers or justifies initiation of the process. As in the case of Chapter 9 of the U.S. Bankruptcy Code, recourse to the facility by a sovereign debtor should preferably be based on its actual or prospective inability to service its debts as they become due, that is, illiquidity.

Right to petition the facility. The next question is, Who should have the right to petition the facility for debt adjustment? Most national laws permit the debtor or a group of its creditors to file a petition initiating a proceeding. However, under Chapter 9, only the municipality may file a petition for debt adjustment. In the case of sovereign debtors, the latter voluntary approach would be the preferred and primary method of initiating a debt adjustment procedure. The sovereign debtor is in the best position to know its economic and financial situation and, therefore, also able to foresee any future debt servicing difficulties.

To address the concerns of private creditors, consideration may be given to the possibility of permitting governments of creditor countries (either as creditors in their own right or in the exercise of their diplomatic protection of national creditors) to petition the facility for a sovereign debt adjustment. If this is considered appropriate, the right to petition should be limited to situations where the sovereign debtor's inability to service its external debt has been evidenced by actual cases of debt service payment default.

Consideration may also be given to the possibility of authorizing the Managing Director of the IMF to notify the facility of a situation in which, in his or her opinion, the sovereign creditor should have filed a petition, in which case the process could be initiated *ex officio* by the facility. The Managing Director's initiative would be preceded by appropriate consultations, in particular with the sovereign debtor and the governments of major creditor countries.

Under each of the above three methods of accessing the facility, the final determination as to whether initiation of the debt adjustment process meets the required conditions would be made by the decision-making organ of the facility.

Automatic Stay

Sovereign debtors usually own or maintain property and other assets, including bank accounts, in several foreign countries. To ensure a smooth

debt adjustment process and the equal treatment of all creditors, it is essential that there be no rush of creditors to courts around the world to obtain judgments against, or to attach the assets of, the sovereign debtor concerned. Therefore, the constituent document establishing the facility (which could be an amendment to the IMF's Articles or a new treaty) could provide that, once the debt adjustment process has been initiated, an "automatic stay" comes into effect immediately, and this would have the effect of restraining all creditors (secured and unsecured) from commencing or continuing all lawsuits for debt collection or enforcement of liens or judgments. In addition, the constituent document establishing the facility could prohibit the debtor from making payments to particular creditors.

Under many national laws, the filing of a petition results in the suspension of any debt collection action or lien perfection by creditors. This stay of legal actions allows an orderly process of negotiations to take place. Either as a direct effect of the constituent document establishing the facility or through specific enactment, this provision would have to become part of the law of the signatory countries, and domestic courts would thus have to enforce this provision.

The period of time during which an automatic stay continues varies among jurisdictions, but the actual number of days typical in the case of a private sector debtor might not be appropriate for a sovereign debtor, whose affairs are considerably more complex. Given the wide diversity of potential users of the facility and the complexity of their cases, it might be appropriate to make the length of a stay discretionary. Therefore, a limited period of time (up to six months), but subject to a limited number of subsequent extensions (for example, two extensions of up to three months each), might be envisaged.

Interim Financing

The debtor may require additional financing during the period of the automatic stay and while a plan is being developed and approved. In many countries, certain lenders develop a specialization in providing such interim financing to companies in reorganization proceedings. Such lenders are likely to provide financing only if they receive preferential status for their loans, perhaps in the form of a security interest. To facilitate this process, the constituent document establishing the facility could provide that actions to enforce the security interest for such interim financing would be exempt from the application of the automatic stay.

Preparation of a Debt Adjustment Plan

Once the debt adjustment process has been initiated with the facility, a debt-adjustment plan would need to be prepared. Most national laws per-

mit the court to appoint a third party to gather information concerning the financial condition of the company. Many national laws also provide that the court or its appointee prepare the plan, while some provide that it is the debtor that prepares and presents a plan to the creditors. Under Chapter 9, it is exclusively the responsibility of the municipality to do so. In the context of sovereign debt adjustments, it may be more appropriate for the facility first to undertake a study of the debtor country's financial situation, and then work with the debtor, which will prepare its plan for debt adjustment in consultation with its creditors.

The first step would be to undertake a detailed study and analysis of that particular country's debt problems, which may vary from severe balance of payments difficulties calling for immediate action to structural, financial, fiscal, and transfer-of-resources problems requiring longer-term adjustment measures. This would involve examination of the domestic economic situation of the country; assessment of the impact of external factors (for example, export performance and prices/markets for major commodities) on the developmental and financial problems of the country; review of the country's assets, including those of state enterprises, and ownership of natural resources; estimates of short- and long-term capital requirements and likely availability of funds; review of the country's external debt management policies, projected debt servicing requirements, and measures adopted to avoid debt servicing difficulties; allocation of scarce resources to competing claimants for use of these resources (that is, external debt servicing demands versus demands for funding of domestic programs); and examination of the need for the country to undertake specific adjustment measures.

In preparing its debt adjustment plan under the overall supervision of the facility and with the assistance of the staff assigned to the facility, the debtor would need to consult with its main creditors so as to ensure that the finally negotiated debt adjustment plan will be approved. As is required under most national laws, the debt adjustment plan should provide for fair and equitable treatment of the different classes of creditors, taking into account differences between unsecured and secured (or other preferred) creditors. It would likely propose appropriate concessionary arrangements designed to match the debtor's capacity to service the debt (for example, extensions of loan maturities, reduction in interest rates, and partial or full write-off of arrears).

The plan could also provide, if necessary, for additional financing from the same or other creditors to tide the sovereign debtor over while the debt adjustment plan is being implemented. There should be no obligation to provide such financing; rather, incentives should be offered, such as adequate security or preferred creditor status.

In terms of staff resources and expertise, the facility is not likely to be equipped to undertake the complex task of studying and analyzing the country's debt problems. The IMF possesses expert knowledge and understanding of these factors and, with the possible assistance of the World Bank, could undertake such study and analysis as a service to the facility.

Finally, while the debt adjustment plan is being prepared, approved, and implemented, due regard should be paid to the sovereign character of the debtor. For example, Chapter 9 forbids interference by the court (unless the debtor has earlier so agreed in a plan) with any of the municipality's political or governmental powers, property, or revenues, or use or enjoyment of any income-producing property. It would be wise to include similar restrictions in the constituent document establishing the facility.

Acceptance and Confirmation of a Debt Adjustment Plan

After the sovereign debtor prepares the plan, it would have to be presented to creditors for their approval. National laws differ as to the requirements for determining minimum acceptance by creditors. The constituent document establishing the facility could require, similar to Chapter 9, that creditors be put into classes and that each class of creditors votes on the debt adjustment plan. In Chapter 9 cases, the plan designates the number of classes and which creditors are in each class. The constituent document establishing the facility could provide for a limited number of classes, for example, secured creditors, general unsecured creditors, and subordinated creditors. Following the U.S. approach, it could also provide that, in order for the plan to be confirmed, it would have to be approved by a majority of creditors in each class, representing at least two-thirds of the amount of all claims of such class. It could further provide that, in the event that one or more classes of creditors fails to approve the plan, the facility may deem the plan approved if the plan does not discriminate unfairly and a majority of creditors, representing at least two-thirds of the total amount of debt owed to all creditors, has approved the plan.

Finally, the facility would confirm the debt adjustment plan as accepted by the sovereign debtor and its creditors. Then, the plan could be enforced against all creditors, including creditors who voted against the plan.

Implementation of a Debt Adjustment Plan

Under most national laws, once a plan has been accepted it applies, with certain limited exceptions, to all creditors, even those who dissent-

ed. If the facility is established by treaty (either through an amendment to the IMF's Articles or a separate treaty), the debt adjustment plan could be enforced through domestic law and domestic courts on dissenting creditors. As noted above, the debt adjustment plan could include mechanisms, such as exit bonds, debt equity conversion schemes, and buyback arrangements, so as to permit dissenting creditors to leave the lending syndicate if they so wish.

Monitoring Debtor's Performance Under a Debt Adjustment Plan

After the debt adjustment plan is confirmed by the facility, the debtor's compliance with the plan would need to be monitored. Under national laws, the court oversees compliance with the plan. Under Chapter 9 proceedings, the court retains jurisdiction over the case for "such period of time as is necessary for the successful implementation of the plan,"[4] but closes the case "when the administration of the case has been completed."[5] The case may be reopened "to administer assets, to accord relief to the debtor, or for other cause."[6] Consequently, if the debtor fails to perform in accordance with the debt adjustment plan, the court may take steps to enforce the terms of the confirmed plan or may consider a proposal to modify the confirmed debt adjustment plan. The facility could be given powers similar to those of a national court.

Under some sovereign loan agreements (through "claw-back" clauses), the creditors have the right to request a modification of the plan if the debtor's financial condition improves significantly within a specified period of time—for example, one year—from the confirmation of the plan. Similarly, under the facility, the debtor's performance of the terms of the debt adjustment plan would need to be monitored, and subsequent adjustments in the plan could be envisaged. As suggested above, the task of monitoring the implementation of the plan could be delegated to the IMF. However, the authority to reopen the case and modify the debt adjustment plan would remain with the facility.

Chapter

14 Legal Remedies in the Event of a Sovereign Debt Default

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Overview

The growth in sovereign debt that began during the Second World War has continued through peace, war, recession, and prosperity. Fondness for state borrowing has spread from developed to developing countries, and from market-based economies to socialist ones, which then became highly indebted "economies in transition." The difficulties of servicing this debt, particularly by developing and transition borrowers, have triggered crises in financial institutions, bond markets, and currency exchanges. The continued development of highly liquid portfolio capital markets, particularly in developing and transition countries, has had a multiplier effect. This effect stems from the possibility that a sovereign default could trigger a stampede of disinvestment, or what economists call an investor "rush for the exits." Fears of possible "contagion effects," where a single sovereign default leads to a "rush for quality" domino effect as investors move capital to more secure venues, have made economists even more concerned with the potential multinational effects of the default of a single sovereign.

The Mexican peso crisis in late 1994 forced the world's financial community, and in particular the governments of the Group of Ten countries[2] and international financial institutions, to give the problem of sovereign illiquidity heightened attention.[3] Although meetings have been held and reports written, so far no consensus has emerged as to what the response of the international community should be. However, some observers fear that sovereign defaults among a number of developing and transition countries may loom menacingly on the horizon. Ministers of finance, central bankers, and financial experts in both the public and private sectors continue to warn of the consequences to the world economy of a major sovereign liquidity crisis.

A primary issue is what constitutes "sovereign debt obligations." The answer to this question depends on what constitutes "sovereign debt." This term has at least two different definitions, depending on the point of view of the speaker. First, if one is an economist, one is as likely to use

the term "public" or "government" debt and to think in terms of total borrowing by the entire governmental sector. Public debt would include those obligations that are, or would as a practical matter become, a burden on the state revenues of the particular polity.[4] These obligations would include not only those of the national state (including contingent liabilities through loan guarantees), but also of political subdivisions, such as provinces or municipalities; related governmental institutions, such as central banks; and state-owned enterprises, whose financial well-being is ultimately supported by the public treasury. This latter category would include not only those entities whose debts are formally or legally guaranteed by the state, but also other entities that the state could not, as a matter of practical politics or economics, allow to fail.[5]

Second, if one is a lawyer, what defines sovereign debt is less an issue of the effects of the obligation on state revenues and more a question of who has incurred a legal obligation to pay and what special protections are afforded to that borrower if it is a sovereign. A lawyer advising either a borrower or a lender will be concerned with the specific rights and responsibilities that the law attaches to sovereigns, as opposed to nonsovereign borrowers or lenders. In particular, a lawyer will be concerned with the ability of a creditor to use legal process against the sovereign borrower to secure financial redress in the event of a default. Among the most important issues of concern will be the special legal immunities of sovereigns, known as sovereign immunity. These immunities may restrict the ability of a creditor to find a court that can exercise the necessary personal and subject matter jurisdiction so that the creditor may sue the sovereign for a judgment, or to have his or her judgment executed on the sovereign's assets. These issues are largely the subject of this chapter. However, there is another reason why sovereign debt differs from private, and that is because sovereign states cannot take advantage of bankruptcy laws. This means that, in the event of a default, the sovereign cannot turn to a bankruptcy court for a temporary stay of suits by creditors. Private issuers, on the other hand, are afforded the protections found in bankruptcy laws.[6]

Public finance economists are also most likely to be concerned with "external debt" as opposed to "domestic debt." From the economist's perspective, external debt is debt held by foreigners, and therefore, such debt has a primary effect on a country's balance of payments and the pricing of its currency. In the case of developing and transition countries, it is typical for this debt to be denominated in foreign currencies. This means that such debt cannot be monetized by the debtor through the printing of more money. Moreover, when the country (and its central bank) run out of foreign currency to pay state debts, private economic actors may run out of foreign currency as well. The country may then

impose exchange controls that may give rise to defaults on the repayment of private sector foreign-currency-denominated debt as well.

From a lawyer's perspective, these distinctions are imprecise. For example, a given sovereign bond issue may be subscribed by both foreign and local residents, while the same governmental issuer may issue bonds denominated in both local and foreign currencies. For the lawyer, the importance of the type of debt lies in the legal nature of the obligation. This chapter concerns international debt—that is, debt where payments of interest and principal are legally required to be made, at the option of the lender, in a foreign country. This distinction is important, because debt that is payable in foreign jurisdictions is almost always subject to foreign laws; in fact, international debt typically provides that it is governed by the laws of a particular foreign jurisdiction and that this jurisdiction is also a forum for dispute settlement. Two important consequences flow from this. First, in the event of a default the government typically cannot, through its own laws, protect itself from being sued in a foreign court. Second, while the government might, by changing its own laws, be able protect its domestic assets from being attached in execution of judgment, it cannot similarly protect its foreign assets from being attached.

Finally, international debt typically includes clauses waiving any immunities it might have to execution of judgment against foreign assets. In most cases, the laws of foreign sovereign immunity, meaning those laws that restrict the jurisdiction of a court when the defendant is a foreign sovereign, will respect such waivers and will not allow the sovereign unilaterally to cancel them. This means that there is a potential for creditors to use legal process in a foreign jurisdiction either to collect from defaulting debtors or as a tool to apply pressure so as to improve the terms of any negotiated refinancing. Also of great importance, international debt is often payable (either directly or at the option of the holder) in a foreign currency.

Debt is domestic, on the other hand, where payments are made within the country of the issuer. It is usually governed by domestic law, which the government can use to protect itself from both suit and from attachment. At the same time, because domestic debt includes no waivers of immunity, foreign sovereign immunity laws typically will protect the sovereign's foreign assets from attachment. Therefore, creditors would generally not be able to use litigation to collect from defaulting debtors, or to use litigation to improve the terms of any refinancing.[7] Each of these issues is discussed at greater length later in this chapter.

The economist looks to the general consequences of a default on the economy, while the lawyer looks to the specific consequences of a default for his or her client. However, the general effects will depend on the sum

of the particular effects. The nature of the legal consequences of a default by a sovereign debtor will determine, in large part, how sovereign borrowing will be priced in the future. Therefore, the legal nature of sovereign borrowing will determine the extent of remedies. How the law of sovereign immunities affects the ability of the borrower to collect on a default will determine, again at least in part, the market's response to a default. In addition, by changing the legal consequences of a default, the market's reactions can also be changed. For these reasons, the economist, whether in a ministry of finance or a central bank, should be concerned with the protections afforded by sovereign immunity.

Some commentators have suggested that in certain cases of sovereign default creditors should not be permitted to take legal action to enforce their claims. Instead, sovereign debtors should be permitted a "breathing period," similar to that provided in national bankruptcy laws, to allow them time to negotiate a debt rescheduling or adjustment with their creditors. During this time, the sovereign would also engage in an economic restructuring to provide for additional resources to pay creditors. In addition, as provided in national bankruptcy laws, a reasonable settlement should result in a legally binding contract between the debtor and all creditors, even if all creditors do not consent.[8] Such a new world might be implemented through changes in the rules of sovereign immunity. These issues are addressed in the final part of this chapter.

The fear of legal redress against defaulting sovereign debtors is probably not the most important aspect of a sovereign default. The most important aspect is the reaction of the sovereigns' creditors and of markets to a sovereign default. If a borrower defaults, lenders either will not lend additional funds or will demand higher interest rates to compensate for the additional risk of lending to a defaulting borrower. Nevertheless, it may be possible for certain creditors to reduce their losses in the case of a default through recourse to legal process or to apply pressure on a sovereign with which a refinancing is being negotiated.

Creditors to foreign sovereigns may be official (governments and international financial organizations) or private. Private creditors, excluding short-term trade credits, can be divided into two groups—those that make syndicated loans and those that extend credit on a party-to-party basis, often, although not always, through bonds.[9] Although there have been exceptions, political considerations often prevent official creditors from seeking legal redress in the event of default by a sovereign borrower.[10] Again, despite exceptions, most syndicated creditors do not seek legal redress for reasons discussed immediately below.[11] In the past, most sovereign defaults have been handled outside the courts, either bilaterally

or in the Paris and London Clubs, which deal with official and private debt, respectively.

Before the debt crisis of the 1980s, most sovereign debt was in the form of syndicated loans. Those loans typically included sharing clauses, which meant that any separate creditor in the syndicate would have to share the benefits of asset attachment with all other members of the syndicate in proportion to outstanding exposure. However, since the resolution of the debt crisis, the majority of debt contracted by sovereigns has been securitized—that is, through notes or bonds. In the case of securitized debt, there are no sharing clauses.[12] This means that, in the event a bondholder recovers assets through legal process, he need not share them with any other creditor.

For party-to-party creditors or for bondholders, however, legal process may remain a practical option. When a sovereign debtor fails to make a payment due on an obligation, these creditors may do many things besides sue to recover damages, including trying to negotiate a rescheduling or seeking redress at the political level. However, even good faith negotiations and influential political pressure will be affected by the legal remedies available. Those legal remedies will depend on the sovereign immunities recognized in the particular court in which a suit may be conducted against the sovereign defaulter.

Jurisdiction

In order to secure an effective legal remedy against a defaulting borrower, the creditor needs two things: a judgment providing that damages of a specific amount are due, and sufficient assets of the borrower to attach or seize to secure the judgment.[13] Of course, a court cannot serve as a forum for a dispute unless it can exercise jurisdiction over the defendant; nor can a court execute judgment by attaching or seizing assets unless it can exercise jurisdiction over those assets. As noted previously, the laws of sovereign immunity may restrict one or both of these jurisdictions. If so, it may be difficult to find a court that either can hear the original case for default and damages or can order attachment or seizure of sufficient assets to make the judgment effective.

Judgment

The residence of the debtor is recognized in most legal systems as the most basic ground for exercising jurisdiction. It may, in fact, be possible to secure a judgment against a sovereign debtor in one of its own courts. However, it may also be that the government has enacted laws that either

grant complete immunity from suit to the government or that may even alter the terms and conditions of the debt contract in such a way as to render the underlying debt effectively void.[14] For this, as well as for other reasons to be explained below, few creditors are likely to sue a sovereign for judgment in the courts of that sovereign.

Many countries also recognize a number of other bases of jurisdiction to sue.[15] These bases will usually be sufficient to allow the creditor to sue the sovereign somewhere other than in its own courts. Perhaps the most important of these bases for jurisdiction is that stemming from a contract provision according to which the parties consent to submit their dispute to a particular court. Most sovereign loan agreements and bond terms and conditions include specific provisions whereby the parties consent to jurisdiction and choose the governing law. Parties to international loan contracts typically specify that the contract will be governed by the law of a particular jurisdiction and that the courts of that jurisdiction will serve as a forum for dispute settlement. Among the most common jurisdictions for choice of law and venue are New York, London, Frankfurt, and Tokyo. Courts in these jurisdictions have generally recognized and applied these choices.

The doctrine of foreign sovereign immunity comes into play in cases reaching the courts of such jurisdictions.[16] The immunity of foreign countries from the jurisdiction of national courts has a long history in the law. Traditionally, courts would not exercise any jurisdiction over a foreign government or its assets unless it expressly consented. Over time, this adherence to an absolute theory of immunity has given way to the more restrictive view, which allows foreign countries to retain immunity only with respect to their public acts (*jure imperii*). When acting in a commercial or private manner (*jure gestionis*), countries are denied immunity. The rules regarding immunity against attachment of assets in execution of judgment, which are discussed in greater length below, have changed less.

The courts of most countries or their political subdivisions, including courts in the United States, the United Kingdom, and Germany, currently adhere to the restrictive view of sovereign immunity from jurisdiction. While the courts in Japan do not, such provisions often exist in relevant bilateral treaties.[17] After relying primarily on common law, in the 1970s the United States and the United Kingdom enacted specific statutes limiting the sovereign immunities of foreign states to their governmental acts.[18] The U.K. Act states that "any loan or other transaction for the provision of finance" is a "commercial transaction" not entitled to immunity.[19] The U.S. Act leaves the term "commercial activity" to be defined by the courts,[20] although it has been understood to embrace loan

contracts with the proper nexus to the country. This means that when the country acts as a borrower, sovereign immunities do not apply in these jurisdictions, and the country is subject to the jurisdiction of a court.

In most instances of international sovereign borrowing, the general application of a court of the restrictive interpretation of sovereign immunity is not relevant because, as noted above, the terms and conditions of the borrowing typically include an express consent by the debtor to the jurisdiction of a specific court. This consent constitutes a waiver of immunity from jurisdiction, even in Japan.[21] Once jurisdiction has been extended by a court, the securing of a money judgment for damages may follow.

A judgment by itself is of little use unless there are assets available to satisfy the judgment. Therefore, if a sovereign debtor has insufficient attachable assets in the forum where a judgment was rendered, a creditor may begin proceedings in other jurisdictions where attachable assets exist. The creditor will then have to begin the suit anew, unless it is able to obtain recognition and enforcement in the new forum of the prior judgment. This usually means that the creditor will be forced to seek recognition of the prior judgment in the court in whose jurisdiction the sovereign's attachable assets lie.

Rules concerning the recognition of foreign judgments have a high degree of uniformity among most jurisdictions. For example, under the Uniform Foreign Money Judgments Recognition Act—currently in force in New York[22]—a foreign judgment may be recognized and enforced if it is final, conclusive, and enforceable where rendered, unless it satisfies one of the grounds for nonrecognition, which should rarely be applicable.[23] The Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters,[24] which governs recognition and enforcement of judgments among the member states of the European Union, has rules similar to the New York statute. The rules of other important financial centers are similar.[25]

Inasmuch as the conditions for recognition and enforcement are quite uniform and reflect generally accepted principles, there should be little difficulty in making an initial judgment legally enforceable in other forums located in major financial centers. However, the problems of executing that judgment are the same as they would be for the initial judgment.

Satisfaction of Claims

Assets of a country that are held within its own jurisdiction are likely to be protected against execution of judgment by domestic sovereign immunities.[26] Therefore, the only way to execute a judgment would be

to find and attach assets held abroad. There are three types of assets that may be located in foreign jurisdictions that could be used to satisfy a judgment against a sovereign creditor. These are property owned directly by the sovereign, property of legal persons that are owned by the sovereign, and property of the sovereign's central bank.[27] Once such assets are located, the creditor would move the court in whose jurisdiction they are located to order attachment.

While attachment of assets can serve as a judicial remedy to execute a final judgment, in most jurisdictions a court will order attachment before a final judgment is ordered. The purpose of such "prejudgment" attachment is to prevent a defendant from moving the assets outside of the jurisdiction of the court so as to evade any final order of execution. The standards for prejudgment attachment vary among jurisdictions, but often require some showing that there is a well-founded fear that the defendant will remove otherwise attachable assets from the court's jurisdiction.[28] The ability to receive an order of prejudgment attachment, therefore, can be helpful both with regard to enforcing a final judgment later and with regard to applying pressure on a debtor in the context of any refinancing negotiations.

The ability to secure either postjudgment attachment or prejudgment attachment will be limited both by the availability of any assets within the jurisdiction of the court and by the protections afforded by sovereign immunities to those assets. First, the assets in question must be the property of the debtor. For example, if the debtor is the state, but the property (such as official foreign exchange reserves) is held by the central bank, the reserves may not be amenable to attachment even if they are held within the court's jurisdiction. Second, the waivers of immunities exercised in most sovereign borrowing usually include immunities against execution, including both pre- and postjudgment attachment. However, a number of jurisdictions severely limit the ability of a sovereign to waive such immunities. Where the central bank is party to the debt, the waiver is more likely to be limited. In both situations, sovereign immunities may affect the ability of the creditor to attach assets of the debtor. The rest of this section examines what assets are likely to be amenable to attachment.

Property Owned Directly by the Debtor

A sovereign may own property located in various foreign jurisdictions. This includes commercial bank accounts, buildings and property, and other assets. Under a typical waiver, such property might appear to be attachable. Nevertheless, the U.S. statute extends immunity that cannot be waived to any property used in connection with a military activity and of either a military character or under the control of a defense agency.[29]

The U.S. statute also provides immunity to immovable property used for a diplomatic or consular mission or as the residence of the chief of such a mission.[30] This immunity extends to bank accounts used to maintain these assets. Such immune property may constitute the majority of a defaulting sovereign's foreign assets in the jurisdiction in question.

One major issue involves a country's official foreign reserves. Typically, the official reserves may be the property of the central bank, and not of the state itself. If, in these circumstances, the state is the defendant, it is unlikely that the official reserves would be attachable. The majority of sovereign debt contracted in the past ten years is that of the state, which would mean that official reserves would be safe. Nevertheless, in some instances, it is the central bank that acts as the borrower. In these cases, the central bank may limit its waiver of immunities so that official reserves are not attachable.

As with the U.S. statute, the U.K. statute protects some property from attachment, regardless of waivers, including the premises and physical property of diplomatic and consular missions and the means of transport of such missions.[31] It also appears that military property of a foreign country may be immune from attachment.[32] The French and German laws appear to protect certain assets of a foreign government from attachment either on the ground of their inviolability (diplomatic missions) or as part of the foreign government's "public domain" (for example, military installations).[33]

There would generally appear to be little attachable property of worth held directly by some sovereigns in foreign jurisdictions. Possible exceptions might include cases where title to an airplane, ship, or other physical property was held directly by the sovereign—that is, not through another legal person. Governments may also hold assets in foreign bank accounts, but, with the exception of official reserves held by central banks, these amounts may be limited.

However, in the context of rescheduling negotiations, even the attachment of limited amounts of foreign exchange assets could exert considerable pressure on a country to agree to a relatively more favorable settlement for creditors. One example of this is *National Union Fire Insurance Company of Pittsburgh, PA, v. People's Republic of the Congo.*[34] That case involved a suit by a London Club creditor against the Congo for $22.5 million in damages stemming from the Congo's default on a credit facility. The suit was filed during restructuring negotiations. District Judge Kimba Wood, in agreeing to execute judgment in New York, commented that the strategy of seeking to attach assets "will certainly serve to disrupt attempts to complete the rescheduling effort and will definitely have an adverse effect on Congo's international trade and

banking business. Although we would prefer to avoid this situation, it is clearly a viable, and rational strategy."[35]

It is also possible that a judgment creditor may attempt to attach a loan disbursement to be made by another creditor to the debtor government. Once all the requirements of the loan agreement are fulfilled, such that the debtor government has the right to receive the loan disbursement, the government is said to have a "claim" against the lender for the amount of the disbursement. As with any other claim, this could be subject to judicial attachment. The result of such an attachment would be that the court would transfer the right to receive the loan disbursement from the debtor government to the creditor. The lender would continue to have a contractual claim against the country to repay the loan, notwithstanding the fact that the proceeds of the disbursement were never received by the debtor government. However, because the debtor government would presumably be less willing to repay an amount that it never actually received, a commercial lender could be expected, as a matter of practice, to exercise its right to cancel the loan agreement and make no further disbursements.[36] Thus, while such an attachment order would be unlikely to enable the creditor actually to seize a government's assets, it could be an effective means of cutting off any resumption of access to private financing, thereby exerting pressure on the government to negotiate a settlement. Such a strategy could be pursued even if the size of a creditor's claim is small in relation to disbursement.

Property of Separate Legal Persons That Are Owned by the Sovereign

Generally, jurisdictions respect the separateness of different legal persons. Under this principle, the property of private or even public entities is not attachable for the satisfaction of claims on the sovereign debtor. However, such a separation may be ignored in special circumstances. In the United States, a creditor may not generally execute judgment on the assets of a separate legal person who is not a party to a sovereign default, even if the legal person is wholly owned by the sovereign.[37] The "corporate veil" can be pierced, however, where "(i) the 'corporate entity is so extensively controlled by its [foreign sovereign] owner that a relationship of principal and agent is created' or (ii) the separate corporate entity of a foreign instrumentality is abused to work fraud or injustice or to defeat overriding public policy."[38] This has happened on rare occasions and only under special circumstances.[39] The United Kingdom has similar rules.[40]

In France, although the law is not yet clearly settled, the cases show an unwillingness to authorize the seizure of other entities' assets when such entities are not fully owned by the sovereign debtor or when the sovereign debtor could have claimed immunity from jurisdiction for the

relevant debt.[41] In a case where the creditors of one state-owned entity were seeking to attach assets of another entity owned by the same state, it was held that the attachment would only be possible if the creditors demonstrated that there was no separation of assets and liabilities between the two entities.[42]

Property of the Central Bank

A sovereign's central bank often maintains foreign exchange accounts in several major financial centers, such as New York, London, Frankfurt, or Tokyo. However, a number of important obstacles prevent the attachment of such assets. First, at least for debt contracted in the past ten years, the central bank is unlikely to be the debtor. Before the debt crisis of the 1980s, sovereign borrowing was frequently implemented through the sovereign's central bank or with its guarantee or participation. In these instances, a waiver of the central bank's immunities was often a condition for the loan. However, since that debt crisis central banks of highly indebted countries have tended to become more independent. Moreover, bond offerings in recent years have generally not involved central banks. If the central bank is not the debtor, it would not be a party to the suit by creditors to recover damages due to a default, and its assets would not be amenable to attachment. This is because, in most cases, the central bank is a separate legal entity and, as any other entity, it may invoke its separateness from the state against actions brought by the state's creditors. Specific legislation in the key jurisdictions of New York and London has made clear that a claim by a defaulting country against its central bank for foreign exchange assets does not make those assets the property of the state and therefore subject to attachment.[43]

In some cases, sovereign debt is still contracted by the central bank. However, again at least since the debt crisis of the 1980s, in a number of these cases the terms of the indebtedness have expressly stated that the waiver of immunity contemplated in their terms does not apply to foreign exchange assets or official reserves.[44] Therefore, the lack of participation of central banks or the exclusion of central bank assets from the coverage of sovereign immunity waivers is likely to exclude central bank foreign exchange assets from the list of assets available to execute a judgment. Finally, there are a limited number of recent cases where central banks have contracted debt in the form of bonds and have waived immunities even with regard to official reserves.[45]

As noted earlier, the property of a foreign country or its instrumentality is not immune to prejudgment attachment if the country or entity has explicitly waived its immunity from prejudgment attachment and

the purpose of attachment is to secure satisfaction of judgment.[46] However, the U.S. Foreign Sovereign Immunities Act (FSIA) is unclear with regard to prejudgment attachment of central bank assets. Section 1611(b)(1), which provides that property of a foreign central bank is immune from attachment in aid of execution and from execution, makes no mention of prejudgment attachment. There appears, however, to be a consensus among commentators that such an omission combined with the special status of central banks and their assets[47] means that immunity from prejudgment attachment of central bank assets cannot be waived. The court in *Weston Compagnie de Finance et d'Investissement, S.A. v. La Republica del Ecuador* also concluded that "section 1611(b)(1) purposely did not provide for prejudgment attachment of property of foreign central banks held for their own account."[48] While prejudgment attachment is mentioned elsewhere in the Act and is omitted in the provisions regarding central bank assets, reading such an omission as conclusive may be precarious. Some contend that a foreign central bank, if it so desires, should be permitted to waive immunity from prejudgment attachment just as any other juridical entity is able to do. Temporary restraining orders also may not be issued against the assets of foreign central banks under the FSIA.[49] They are viewed as having the same features as prejudgment attachments and are therefore deemed invalid.[50]

In England, Mareva injunctions, which prevent the removal of assets from the jurisdiction or their disposal so as to frustrate execution of judgment, may be granted. However, with regard to central bank assets such an injunction may only be issued if the central bank gives its written consent to such relief.[51]

In France and Germany, there are no specific statutory exemptions for central bank assets. In Germany, prejudgment attachment is permitted if there is an express waiver.[52] Prejudgment attachment is permissible in France and can be ordered if attachment of the assets involved would be permissible at postjudgment.[53] It remains unclear if in Japan prejudgment attachment would be permitted in the event of a waiver.

In the case of recently contracted sovereign debt where the central bank is not a party, there is little likelihood that, in the event of default, all creditors as a class would be able to attach sufficient assets to satisfy fully their judgments against a defaulting sovereign debtor. Before the debt crisis of the 1980s, most sovereign debt was in the form of syndicated loans. Those loans typically included sharing clauses, which meant that any separate creditor in the syndicate would have to share the benefits of asset attachment with all other members of the syndicate in proportion to outstanding exposure. However, since the resolution of the

debt crisis, the vast majority of debt contracted by sovereigns has been securitized, i.e., notes or bonds. In the case of securitized debt, there are no sharing clauses.[54] In the event of default, a single bondholder, who may have a relatively small investment, may be able to execute at least a part of its individual judgment against a sovereign by attaching assets. In addition, and perhaps of even greater importance, attachment of available assets can be used as a device to apply pressure on a sovereign that is negotiating a refinancing with its creditors.

Should Immunities Be Restricted?

Some commentators have argued that ad hoc immunity from suit and attachment should be made complete for those sovereign debtors that cooperate in good faith with their creditors to reschedule their debts, typically along with structural adjustments of their economies. A few have viewed this as similar to the "automatic stay" provisions often found in bankruptcy laws. However, the protections afforded sovereign borrowers through sovereign immunities are already substantial. It is not clear how much further these protections should be extended.

On the other hand, instead of broadening the concept, sovereign immunities might be narrowed, at least with respect to certain debtors. The main feature of current provisions on sovereign immunities is that protection for debtors extends to all, not just to those who have agreed to make a good faith effort to reach an agreement with their creditors or otherwise resolve their liquidity problem. The question, therefore, is whether, under a hypothetical international scheme that would apply to the obligations of illiquid sovereign debtors, such protection should be limited to those sovereign debtors who are seeking to resolve the crisis appropriately. If it is decided to limit such protection, two immediate problems arise: (i) that of determining which debtors are not taking appropriate action and, therefore, from whom protection should be withdrawn; and (ii) that of designing effective methods of withdrawing such protection. Once these issues are resolved, the problem arises as to how the solutions can be implemented in a legally binding fashion.

The first problem of distinguishing cooperating from noncooperating debtors raises difficult questions of substance (for example, the setting of standards for appropriate behavior, determining time limits during which protection would apply, etc.) and process (for example, who would make such decisions, under what auspices they would be made, what would be the procedure for their adoption, etc.). In order to avoid conflicting assessments by national authorities, it might be appropriate to rely on the judgment of an international organization.

With respect to the second problem of withdrawing the benefits of a regime from noncooperating debtors, consideration could be given to amending domestic sovereign immunities laws to exclude sovereign debtors' assets and those of their public entities (including central banks) in cases where debtors do not act appropriately. This would require changes in existing law in those jurisdictions where central banks deposit foreign exchange—most importantly, the United States, the United Kingdom, Germany, France, and Japan. (There would presumably be a great incentive for a jurisdiction not to make such changes, in that this would adversely affect the jurisdiction's ability to retain central banking assets; this would reduce the jurisdiction's attraction as a financial center.) Because legal changes would, in most cases, require legislative approval, such changes would appear particularly unlikely. Instead, consideration could be given to a contractual approach. For example, loan agreements could provide that in case of default the immunities of the sovereign debtor and its central bank would not be invoked unless a specified international organization has endorsed the default. Such a clause might reduce risk premiums paid by sovereign debtors.

Major changes in the protection offered to defaulting sovereign debtors by legal doctrines regarding their immunities are at this time, and for the foreseeable future, unlikely.

Chapter

15 The Debt-Rescheduling Process: Pitfalls and Hazards

LEE C. BUCHHEIT

The sovereign debt-rescheduling process of the 1980s and early 1990s has never lacked for critics. This chapter is not a contribution to this already rich tradition; rather, its objective is to suggest—from the standpoint of the practicing lawyer advising sovereign debtors in these exercises—a few areas in which future sovereign debt workouts might profitably take a different approach.

The Problem Is Temporary

Nearly everyone involved in the rescheduling process in 1982 and 1983 tried to promote the notion that the external debt problems of the affected countries could be resolved quickly. The problems were pronounced to be temporary liquidity difficulties caused by an unexpected rise in international interest rates and a decline in the price of primary commodity exports of some of the debtor countries.

At the time, there seemed to be good reasons on both sides of the debtor-creditor relationship for nurturing this illusion. The debtors saw their salvation in a speedy return to normal borrowing practices, and a frank assessment of their medium-term debt-servicing capacity would probably not have contributed to early achievement of that objective. For their part, the commercial bank creditors were equally reluctant to acknowledge that their loans were unlikely to be repaid in full any time soon: bank capital ratios were thin, loan loss reserve provisions were small or nonexistent, and stockholders were wholly unprepared for bad news of this magnitude.

In retrospect, this refusal to acknowledge the depth of the problem turned out to be expensive. Faced with what it chose to characterize as a temporary problem, the financial community naturally fashioned temporary solutions. When the debt-rescheduling process began in the early 1980s, only principal maturities falling due during a 12-month to 24-month period were rescheduled at any one time. The payment deferments were relatively brief. The debtors were told that interest had to be paid in full and on time even if this meant borrowing the money needed to pay interest on the old debt from the same banks to which that inter-

est was owed. Above all, the early workout programs assiduously avoided any element of permanent debt relief in the form of a forgiveness of principal or interest. Debt reduction (as opposed to simple debt rescheduling) had to await the final, "Brady Initiative," stage of the crisis starting in 1990.[1]

Unfortunately, the capital markets suspected all along that the problem was far more durable than the remedies seemed to suggest. Renewed access to the voluntary capital markets was therefore continually postponed throughout the 1980s, causing the debtor countries to settle into a ten-year financial and economic coma. Without a source of voluntary new funding from private sources, the sovereign borrowers and their commercial bank creditors had no alternative but to repeat, and then repeat again, the same rescheduling techniques. Before the decade was out, the same item of debt may have been rescheduled three or four times.

What is the lesson of this? If the solution is to come from renewed market access, then there is no alternative but to implement remedial measures at an early stage that are, in the eyes of the market, visibly adequate—or at least not visibly inadequate—to restore the country's medium-term creditworthiness.

The Unanimity Requirement

If no creditor could be forced to join a debt rescheduling at the outset, it seemed to follow that the consent of each creditor would be required before the payment terms of any rescheduled debt could be further amended. This principle was enshrined in clauses of the rescheduling agreements dealing with amendments to the contracts. Except in rare instances,[2] those clauses expressly required the unanimous consent of all lenders before any term of the agreement dealing with the amount or the timing of payments could be changed. The proponents of these clauses argued that they were necessary to assuage the concerns of the smaller lenders about joining restructuring syndicates in which larger, money center banks held a predominate position.[3]

When the initial batch of rescheduled debt fell due and had to be rescheduled in light of the persistence of the crisis, the folly of these unanimity requirements became apparent. Entire rescheduling packages involving tens of billions of dollars were held up because a few lenders with trivial exposures would not agree to sign an amendment to the original rescheduling agreement. For the maverick lender willing to hold its breath as the full bucket of scorn was poured on its head by fellow creditors, the reward was sometimes a quiet buyout of its exposure on

preferential terms. In retrospect, it was a serious mistake for the large lenders to have bestowed such leverage on their smaller colleagues through this unanimity requirement.[4]

Maverick Creditors

The Context

One starts with the premise that a sovereign borrower seeking a generalized debt restructuring cannot pay all of its obligations on their original terms. This is not to say that the sovereign will completely run out of money; there almost always will be some foreign exchange available to the sovereign to cover necessary imports and the servicing of certain types of "preferred" debts, such as credits extended by multilateral institutions. The presumption, however, is that the country has an insufficient supply of foreign exchange with which to service all of its debts. Therefore, certain categories of debtholders are asked to defer or forgive a portion of their claims.

If the majority of those creditors are persuaded of the need for the rescheduling and find the terms acceptable, they may agree to the borrower's request. The sovereign borrower cannot, however, compel any lender to accede to a proposed rescheduling. Most lenders do so and refrain from exercising their legal rights because they are convinced that the borrower does not have the resources to satisfy all of their claims—even at the sharp end of a court judgment—and the creditor group as a whole is therefore better off negotiating, rather than litigating, its way out of the problem.

What about the creditor who is not prepared to go along with the deal? The benign example of such a creditor is one who simply remains unconvinced about the need for a restructuring or is dissatisfied with the terms on which it is offered. The less benign is one who consciously acquires the debt for the purpose of forcing, by negotiation or by litigation, a settlement of the claim on preferential terms.

As seen by his fellow lenders, the maverick creditor is simply capitalizing on their willingness to grant the borrower a measure of debt relief. It is only by virtue of the indulgence shown by the majority of creditors that the sovereign has the money to pay (or to settle on preferential terms) the claims of the more exacting few. This resentment can be aggravated in circumstances where the maverick purchased its claim on the secondary market at a small fraction of its face value, while the original lenders advanced 100 cents on the dollar as the price of their claims. It is like sur-

rendering your seat on a crowded bus in favor of an elderly woman only to watch a teenager wearing a varsity wrestling jacket jump into it.

This situation quite naturally strikes the majority of creditors as unfair and ungentlemanly. The majority is therefore apt to insist that all, or virtually all, similarly situated creditors must accept the restructuring before any of them are obliged to do so. In some recent Brady-style reschedulings done under English law, the sovereign borrower has been asked to covenant that it will not voluntarily enter into any arrangement with a nonparticipating creditor on terms more favorable than those offered in the Brady deal without those same preferential terms being made available to its other lenders.

The Borrower's Dilemma

Faced with a maverick creditor, what is a borrower to do? The borrower has the following options:

- Sweet-talking. For a creditor who is simply feeling unloved and unappreciated, some special attention by the minister of finance or the governor of the central bank may be all that is needed to put things right. Sweet-talking is pointless, however, when the creditor bought the paper with the premeditated objective of staying out of the deal.
- Defer or cancel the rescheduling deal. This tactic may thwart the maverick, but it also thwarts the country's chances of economic recovery. This tactic is a little bit like burning down your house to kill the termites.
- Pay up. There is always the option of paying off the maverick. Apart from the expense and humiliation, this tactic is almost guaranteed to invite a swarm of other mavericks and may jeopardize the main rescheduling program. Moreover, paying off a maverick makes one's other lenders look pretty silly for having agreed to reschedule their own claims. As noted above, some sovereign borrowers have been asked to accept contractual undertakings that effectively prevent any voluntary settlement of a maverick's claims.
- Litigate. The borrower may face one major obstacle if it elects to wage a legal defense against the maverick—the law. The law in most jurisdictions is quite clear that a creditor's claim to recover money advanced to a borrower is (except in very unusual circumstances) legally enforceable. Moreover, the borrower's other lenders will have distinctly ambivalent feelings about a vigorous legal defense. Naturally, they will want to see the maverick frustrated in its effort to snatch (as they will see it) their money from the hapless borrower.

However, the other creditors will not want the borrower to establish a legal defense that could, down the road, be equally applicable to their own loans.

Why should the position of a sovereign debtor in these circumstances be any more delicate than that of a financially distressed corporate borrower? The answer lies in domestic bankruptcy codes. Those codes may provide a corporate debtor with a shield from hostile creditor actions while its financial affairs are being reorganized.[5] Creditors that are reluctant to join a rescheduling program that has been approved by a bankruptcy tribunal may be forced to do so.[6] Perhaps most importantly, the mere availability of a bankruptcy option gives the corporate borrower a measure of negotiating leverage with its lenders. Sovereign borrowers do not enjoy the protection of domestic bankruptcy codes. They are thus vulnerable to individual creditor lawsuits, regardless of how many of their other creditors may have agreed to accept a rescheduling package. It is this peculiar legal vulnerability that a maverick creditor intent on litigation seeks to exploit.

The Defenses

The maverick's legal claim is a straightforward demand for money due but not paid. The sovereign borrower may raise several possible defenses. Among the defenses are the following:

- Eligible assignee. Many sovereign loan agreements and debt restructuring agreements limit transfers of interests in the loans to "banks or financial institutions," a phrase that is almost never defined in the agreement. For reputational reasons, well-established banks and financial institutions rarely play the role of the maverick, particularly the litigating maverick. Most mavericks are obscure, special-purpose entities organized in obscure, underregulated jurisdictions. A sovereign defendant may therefore be able to question whether the maverick was ever entitled, under the terms of the underlying agreement, to take an assignment of the debt on which it is suing.

- Champerty. Under the laws of some jurisdictions, it is illegal to solicit or to take an assignment of a debt obligation for the sole purpose of commencing a lawsuit thereon (a practice known as "champerty").[7] This is not an easy defense to establish, but it may be available in cases where the maverick's only motivation in taking an assignment of the debt was litigation.

- Sovereign immunity. This is not usually a promising defense. Most international loan and restructuring agreements contain very broad

waivers of sovereign immunity, and, even if they do not, the borrowing of money abroad is regarded as a "commercial activity" for which jurisdictional immunity will not be recognized. Sovereign immunity may be relevant, however, in shielding certain assets of the sovereign borrower from attachment in connection with a lawsuit.[8]

- Comity. The U.S. Constitution gives to the executive branch of the government the exclusive power to handle the foreign affairs of the United States.[9] Over the years, the judicial branch has shown itself very reluctant to exercise jurisdiction over foreign sovereigns in a way that might embarrass or interfere with the president's conduct of foreign affairs. Under certain circumstances, U.S. courts will, in the interest of international comity, give effect to foreign governmental actions where such actions are consistent with U.S. law and policy. The availability of a comity defense to a foreign sovereign in a case involving enforcement of external debt obligations turns crucially upon the willingness of the U.S. government to express an interest in the case. The U.S. government has done so only twice since the onset of the debt crisis in 1982, the first time taking the side of the creditor[10] and the second time taking the side of the sovereign debtor in connection with a contract interpretation issue.[11]

Apart from strictly legal defenses, the inclusion of so-called sharing clauses in the underlying loan and restructuring agreements has helped to suppress maverick litigation.[12] These clauses can require creditors who obtain preferential recoveries as a result of setoff or litigation to share those recoveries with their fellow lenders under that agreement. The prospect of such sharing tends to cool the litigious ardor of most creditors.

The maverick creditor problem was a nuisance, but no more than a nuisance, in the sovereign reschedulings of the last decade. If debt problems recur in some of these countries, however, the litigation risk to the sovereign debtors will be greater. Much of the debt has now been sold to investors that are not banks or financial institutions. These investors will be far less susceptible to the kind of geopolitical and regulatory pressure that kept the commercial banks in line during the 1980s.

Afterword to Chapters 12 to 15

FRANÇOIS P. GIANVITI

Resolution of Sovereign Liquidity Crises: Recourse to an Interpretation of Article VIII, Section 2*(b)* of the International Monetary Fund's Articles

In Chapters 12 to 15, the concepts of sovereign debtors, liquidity crises, and external debt were explored; a legal framework for dealing with defaults and rescheduling was examined; the role of sovereign immunities was reviewed; and the pitfalls and hazards of debt rescheduling were addressed. Experts have long sought a means to resolve sovereign liquidity crises through the application of law. One important avenue that has from time to time been suggested is to build on the jurisprudence that surrounds the meaning and interpretation of Article VIII, Section 2*(b)* of the Articles of Agreement of the International Monetary Fund.[1]

Under the Fund's Articles, a member country may impose restrictions on international capital movements[2] and may also impose exchange controls on current payments other than exchange restrictions.[3] It will need the approval of the Fund to impose restrictions on the making of payments and transfers for current international transactions.[4] Therefore, it has been suggested that a sovereign debtor may use these provisions of the Articles either to suspend the payment of its external debt or to replace a payment in foreign currency with a payment in local currency.

However, the problem is whether foreign courts will recognize these actions as a valid exercise of sovereign power against the creditors. Here, another provision of the Articles could be invoked: Article VIII, Section 2*(b)*. The first sentence of this provision reads: "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member."

Undoubtedly, this provision is not clear, and it has received different interpretations in the courts of different countries. Therefore, in order to be able to invoke Article VIII, Section 2*(b)*, a unifying interpretation would have to be adopted. Indeed, the Fund itself could adopt an official interpretation of this provision or any other provision of the Articles. Under Article XXIX, the Fund has the final say in matters of interpreta-

tion of its Articles, precisely in order to avoid conflicting interpretations among its members.

Some have argued that an interpretation of Article VIII, Section 2*(b)* could resolve the problem of foreign courts recognizing a sovereign debtor's decision to postpone the discharge of its external debt or to change the currency of payment (which is also a form of default). However, this proposal raises a number of difficult issues.

First, although an interpretation by the Fund would be binding on its members under international law, it would not necessarily be binding on their national courts. Depending on each country's constitutional system, some form of incorporation of the Fund's interpretation into domestic law may be necessary. Otherwise, the interpretation would be regarded only as advisory, with no more than a persuasive effect. Courts, such as those of the United Kingdom or the United States, which have adopted a narrow interpretation of "exchange contracts," and those of Germany, which have excluded capital movements from the scope of the provision, may not be easily convinced to follow the Fund's interpretation.

Second, an interpretation is a general, abstract statement clarifying the meaning of a rule of law. It is not sufficient by itself to determine the application of the rule in concrete cases. This application requires factual findings and legal characterization, which, even after an interpretation by the Fund, would be the responsibility of national courts. If, for instance, the Fund's interpretation were to state that a loan agreement between a resident and a nonresident is an exchange contract for the purposes of Article VIII, Section 2*(b)*, the determination that a particular contract meets these conditions would have to be left to the national courts. A more difficult issue arises with respect to a particular aspect of this provision, namely, the condition that the exchange control regulation be consistent with the Articles. When the regulation has been approved by the Fund under Article VIII, Section 2*(b)*, there should be no doubt that it is consistent with the Articles. In other cases, where no approval is required, the Fund can only make a declaratory finding of consistency with the Articles, but it would seem that such a finding should be binding on the court. However, the comments to Section 822 of the American Law Institute's *Restatement (Third) of the Foreign Relations Law of the United States* take the opposite view: a finding of consistency with the Articles by the Fund would not be binding on the national courts of the United States.[5] Oddly enough, the opposite conclusion is reached by the American Law Institute for findings of inconsistency: they would be binding.[6]

Last but not least, the main objection to the proposed approach is that Article VIII, Section 2*(b)* only applies to exchange controls, whereas a sovereign debtor's default is not an exchange control measure. The posi-

tion of the Fund on this point is well established. Failure by a debtor to pay its debt is not an exchange restriction. It can be the result of an exchange restriction when the debtor is not allowed to make the payment, but a sovereign state cannot impose a restriction upon itself. A sovereign state can restrict its subjects, but its own decision not to pay is not a restriction. For this reason alone, and setting aside all other considerations, Article VIII, Section 2*(b)* cannot be used to ensure the international recognition of a sovereign debtor's default.

Foreword to Chapters 16 and 17

PHILIP R. WOOD

Two subjects are examined in Chapters 16 and 17, bank secrecy and derivatives. Bank secrecy seems a simple subject, but it is difficult. Derivatives seem difficult, but, from the point of view of contractual law, they are simple. A contract providing that if the value of a basket of securities on the stock exchange goes over 100, the party will pay the counterparty the difference, is elementary. From the legal point of view, its technology is basic. It is simple compared to an offtake agreement with an electricity power station, a construction agreement for a refinery, or a financial lease of an aircraft.

However, what makes derivatives difficult is not the contract—which, when stripped of its jargon, is something most people can understand—but rather the environment. There are two aspects to this environment. The first is prophecy. Derivatives contracts involve taking views on prices, and prophecy has been found to be more difficult than history. The second aspect is the wide variety of general financial law in the world's 311 jurisdictions. The key point is that there is a mosaic of different laws and, therefore, a lack of harmony that results in legal perils and legal expense. Such perils may be favored in life, art, or nature, but in international law they are not commendable.

The worldwide position on netting is important in the field of derivatives contracts. First, in some countries all transactions can be netted without restriction. Generally, this group comprises the common law countries together with the Germanic countries, Scandinavia, and a few other countries.

In a second group of countries, netting is limited or has been prohibited by insolvency law, but there is a statute providing for netting in particular markets or for particular contracts. These countries include Belgium, Canada, France, Ireland, South Africa, and the United States. In some of these countries, it is necessary for the contract to be within the terms of the statute in order for the netting provisions to operate in the case of the insolvency of one party to the derivatives contract.

In the third group, netting is not possible usually because of the absence of the right of setoff in cases of insolvency. This group includes most of the former Franco-Latin countries, including many Latin American countries and African countries. The group also includes Madagascar, the Philippines, and the United Arab Emirates.

Finally, there is a group of countries where the matter has not yet been resolved. This group includes most of the countries with economies in transition, such as Russia. While netting is probably available in China, the bankruptcy statutes in Belarus, Kazakhstan, Russia, and the Ukraine are still too skeletal to deal with the matter.

Honest minds can legitimately hold different views on whether netting should be allowed in cases of insolvency. However, it is unsatisfactory that so many divergent legal frameworks exist. This creates huge legal risks.

Netting is not only important in the context of derivatives contracts but also in relation to payments systems. Some countries, for example, Britain, are moving away from end-of-the-day settlement to real-time gross settlement in order to prevent the daylight overdraft and the collapse of multilateral netting in the evening if one bank should fail. Multilateral netting could, of course, be validated by statute, as has been done in the United States.[1]

The disadvantage of real-time gross settlement is that, when payments are bunched up and the central bank is prepared to grant an overdraft that has to be collateralized, the subject of collateral is more complicated than netting. Again, there are a very large number of countries where problems exist regarding the law of collateral over investment securities. One of the smallest groupings of countries with similar laws on collateral over investment securities—currently comprising the Channel Islands, Japan, Scotland, South Korea, the Southern African countries, and Quebec—may one day be one of the largest groupings. The reason that this small group might become much larger is that it has a moderate, procreditor, mercantilist culture. Its laws provide for reasonably wide security (but not as radical and all-embracing as the English version). Unlike the Germanic, Scandinavian, and the Franco-Latin countries, these jurisdictions—or most of them—have permitted divided ownership in the form of the trust.

Turning briefly to the subject of bank secrecy, one of the key questions is whether a country should criminalize breaches of bank secrecy. Some countries have done so: first, because secrecy is regarded as a fundamental policy (for example, as in Switzerland) and second, because if the rule is civil only it is difficult to prove loss or damage for a breach of secrecy—usually because the breach does not result in any loss. Tax haven countries sometimes criminalize breaches of bank secrecy in order to encourage their domestic banking industry. The objection to criminalization is that it can lead to a stiffening of the law and the need for clear-cut exceptions—the gateways have to be specifically defined by reason of the criminality of the rule.

Chapter 16 | Derivatives Activities of Banking Institutions: Initiatives for Supervision and Enhanced Disclosure

ERNEST T. PATRIKIS AND DOUGLAS J. LANDY[1]

This chapter surveys current initiatives of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) for the supervision and regulation of derivatives activities of banks and other financial institutions. It further highlights the efforts of representatives of financial trade groups, under the coordination of the Federal Reserve Bank of New York, to develop the *Principles and Practices for Wholesale Financial Market Transactions*,[2] as well as initiatives of the Derivatives Policy Group, the Federal Financial Institutions Examination Council, and the Bank for International Settlements to promote enhanced disclosure and supervision of derivatives activities. The chapter concludes with a review of other significant federal initiatives.

Current U.S. Bank Supervisory Initiatives

Board of Governors of the Federal Reserve System

The staff of the Board of Governors of the Federal Reserve System (Board staff) issued guidelines for examiners on *Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations* (the *Trading Activities Examiner Guidelines*)[3] and the *Trading Activities Manual*.[4] The *Trading Activities Examiner Guidelines*, which parallel provisions of the *Trading Activities Manual*, target trading, market-making, and customer-accommodation activities in cash and derivatives instruments at state member banks, branches and agencies of foreign banks, and Edge Act corporations. Principles of the *Trading Activities Examiner Guidelines* also apply to risk management of bank holding companies on a consolidated basis and can be applied to banks' use of derivatives as end users when appropriate. Board staff also issued complementary examiner guidelines specifically applicable to these institutions' end-user derivatives activities entitled *Evaluating the Risk Management and Internal Controls of Securities and Derivatives Contracts Used in Nontrading Activities* (*Nontrading Activities Examiner Guidelines*).[5] The *Nontrading Activities Examiner Guidelines* are direct-

ed at the use of cash securities and off-balance-sheet derivatives contracts to achieve earnings and risk-management objectives involving longer time horizons than typical for trading activities.

Most recently, Board staff issued examiner guidelines entitled *Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies* (*Risk Management Examiner Guidelines*).[6] The *Risk Management Examiner Guidelines* are specifically directed at the risk-management processes and internal controls at state member banks and bank holding companies, and supplement both the trading and nontrading examiner guidelines. Furthermore, the written agreement entered into by the Federal Reserve Bank of New York and Bankers Trust New York Corporation and its subsidiaries regarding the conduct of the leveraged derivatives transaction business by these companies provides additional information regarding the application of the rules set forth in these materials.[7] The following is a summary of the significant provisions of the *Trading Activities Examiner Guidelines*, the *Nontrading Activities Examiner Guidelines*, and the *Risk Management Examiner Guidelines* related to derivatives activities, and on related guidance.

Trading Activities Examiner Guidelines and Trading Activities Manual

Provisions on customer appropriateness. The provisions on customer appropriateness in the *Trading Activities Examiner Guidelines* are not consumer protection provisions, especially if the customer is sophisticated. The purpose of the provisions is to protect the bank from credit risk, legal risk, and the risk of loss of its reputation. A financial intermediary may act as a broker, dealer, or end user. This guidance applies to banks that are dealers, not to those banks that are end users.

First, a bank must ensure that the counterparty has sufficient authority to enter into the transaction. The purpose of this guidance is to ensure that a bank ascertains that the counterparty has authority to enter into and, thus will be legally bound to, the transaction. One type of authority is the authority of an individual to sign agreements on behalf of the institution and to bind the institution to certain levels of exposure. Another type of authority is that of an organization to enter into a particular transaction. For example, does a municipality have statutory authority to engage in a particular derivatives transaction, or is this an *ultra vires* act? Other types of entities, such as pension plans and insurance companies, may need specific regulatory approval to engage in derivatives transactions. In order to determine whether or not these kinds

of authority exist, it is common for banks to look to authorizations of boards of directors or trustees to enter into specific types of transactions.

Second, a bank should take steps to ascertain the character and financial sophistication of the counterparty, including ensuring that the counterparty understands the nature of, and the risks inherent in, the agreed transaction. If the counterparty is unsophisticated, the bank should take additional steps to ensure that the counterparty is made aware of attendant risks. In this regard, the following questions arise: When a bank acts as an advisor regarding a derivatives transaction, does the bank have a fiduciary relationship to the other party? When a bank acts as agent or broker in a swap, what fiduciary duties does it have?[8]

Third, "while counterparties are ultimately responsible for the transactions into which they choose to enter,"[9] when recommending specific transactions to an unsophisticated counterparty, a bank "should ensure that it has adequate information regarding its counterparty on which to base its recommendation."[10] However, an end user may not want to disclose all of its positions to a dealer.

Fourth, in its evaluation of the counterparty's creditworthiness, the bank should consider, in addition to the counterparty's overall financial strength and ability to perform on its obligation, the counterparty's ability to understand and manage the risks inherent in a derivative product. In general, this provision raises the question of whether or not there are classes of counterparties that should be treated differently or will have different informational needs. Moreover, prudent credit management also entails making a judgment about whether a particular transaction is consistent with the counterparty's business and financial strategy and its stated risk appetite.

Provisions on netting agreements. First, banks should have guidelines and procedures in place to determine the enforceability of netting and all other agreements before consummating a transaction. Second, banks should ascertain that netting agreements are adequately documented and have been executed properly. Third, banks should determine the enforceability of netting arrangements in all relevant jurisdictions, notwithstanding the counterparty's insolvency. *The Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries*,[11] known as the Lamfalussy Report, specifies jurisdictions relevant to a netting arrangement. Consistent with the Lamfalussy Report, as well as the proposed and enacted provisions of the risk-based capital guidelines of the Board of Governor's Regulations H[12] and Y,[13] a legal opinion normally would cover: (i) the law of the jurisdiction in which the counterparty is chartered or, in the case of noncorporate entities, the equivalent location; (ii) if a branch of the counterparty is involved, the

law of the jurisdiction in which the branch is located; (iii) the law that governs the individual derivatives contracts covered by the netting agreement; and (iv) the law that governs the netting agreement.

Provisions on board of directors and management oversight. The provisions on board of directors and management oversight deal with several issues. First, the risk-taking activities of an institution should be governed by policies approved by the board of directors. The board of directors should regularly be informed of risk exposure and risk-management issues, and periodically should review and approve significant risk-management policies and procedures, particularly those that define risk tolerance. Accordingly, the board of directors should conduct discussions with senior management regarding the risk-management process and risk exposure.

Second, senior management should oversee trading operations and ensure that relevant policies and procedures are adequate. This function includes regular evaluation of policies and procedures for conducting trading operations; discussion of risk-management functions with the board of directors, staff, and traders; and ensuring that derivatives activities are allocated sufficient resources to manage and control risks.

Third, management must create a risk-management function that is fully independent of trading management. This function should report trading risks, profits, and losses at least daily to managers who supervise but do not themselves conduct trading activities. Reports should be provided to senior managers and directors with a frequency and in a form that will enable them to judge the changing nature of the institution's risk profile. The personnel staffing the risk-management function should understand the risks associated with derivatives and other instruments that are traded, and their compensation should not be tied too closely to the profitability of trading, in order to avoid potential incentives for excessive risk taking. In addition, the head of the risk-management function should have sufficient authority and stature to provide an effectively independent assessment of the level of risk exposure.

The objective of the guidelines on senior management and board of directors oversight of derivatives activities is to ensure that the board of directors provides the policies and guidance and exercises the overall supervision requisite to management's operation of the bank's derivatives business effectively and in a safe and sound manner, while leaving to management the responsibility for day-to-day operations and operational oversight. The board may delegate to senior management, to the extent consistent with the *Trading Activities Examiner Guidelines* and the *Trading Activities Manual*, authority to determine what markets to enter and which derivatives products to offer, to implement and enforce broad

risk-management policies and overall limits that the board has approved, to review internal controls, and to otherwise supervise the bank's derivatives operations.

It follows that a bank's board of directors should review the overall strategy and nature of a bank's derivatives activities and risk-management policies that senior management presents to the board. The board also should receive periodic reports from senior management, at intervals established by the board, on the level and nature of the bank's derivatives activities, resulting exposures, and other matters that management believes should be brought to the attention of, or approved by, the board. Although these supervisory guidelines refer to a risk-management function, in practice they also apply to banks that separate out market risk and credit-risk-management functions.

Provisions on risk management. Generally, the risk-management process for trading activities should be integrated into the overall risk-management system to the fullest extent possible. Risk measurement should be comprehensive. All material risks should be measured, and all trading operations should be covered. The *Trading Activities Examiner Guidelines* provide specific guidance on management of credit, market, liquidity, operational, and legal risks involved in derivatives trading.

Derivatives serve a necessary and constructive purpose in helping to manage risk. One objective of the supervisory guidelines is to ensure that banks manage risks posed by derivatives so that derivatives will be used safely and soundly. Key components of risk management are an independent risk-management system; a strong internal control environment; and an integrated, institutionwide system for measuring and limiting risk. Integral to a strong internal control environment is sufficient separation of duties, complete separation of front-office (trading) and back-office operations, a daily revaluation of trading positions independent of trading personnel and management, and an independent validation process for each step of the risk-management process.

This means that institutions need to hire highly skilled personnel not only for their trading floors and risk-management staffs, but also for their back offices and risk-management and internal audit functions. The *Trading Activities Examiner Guidelines* also highlight that risk management is a corporate management issue—the board of directors is responsible for knowing in what derivatives activities the institution is involved and for understanding attendant risks. When considering the importance of complex derivatives, there is also "intellectual risk," How well educated are personnel regarding derivatives, from the trader on the desk up to the board of directors? How can exposures be managed if key personnel from an area are hired away?

An important aspect of risk management is the ability to mark to market and to measure risk. The *Trading Activities Examiner Guidelines* are directed at trading activities. Thus, they do not differentiate between instruments used for hedging purposes and those used for position-taking purposes with respect to measurement of risk.

First, banks should have the ability to mark to market derivatives and all other trading positions on a daily basis.

Second, banks actively dealing in foreign exchange, derivatives, and other traded instruments should monitor credit exposures, market risk exposures, trading positions, and market movements at least daily. Banks should strive to monitor more active instruments on a "real-time" basis, as appropriate.

Third, banks should calculate market risk exposures at least daily using a measure such as value at risk (VAR).[14] VAR measures the potential gain or loss in a position, portfolio, or institution that is associated with a price movement of a given probability over a specified time horizon. Although a bank may use a risk measure other than VAR, the measure must be comparably accurate and rigorous.

Fourth, stress tests should be quantitative and also contain qualitative analyses, such as contingency plans. Analyses of stress situations should not only assess the probability of adverse events, but also address plausible worst-case scenarios on an institutionwide basis, which consider the effects of unusual price changes or the default of a large counterparty across both derivatives and cash-trading portfolios, and loan and funding portfolios.

What is the purpose of a stress test? A stress test should demonstrate to an institution both where it may have too much exposure in a particular risk dimension or with respect to a particular counterparty, or where it may be relying on assumed relationships between prices, volatility, or liquidity conditions that could break down. Management should take appropriate action, for example, by scaling back its activities with respect to that risk dimension or counterparty. The stress test should help the bank identify genuine potential threats and how it might manage itself in these scenarios.

Another aspect of risk management is limiting risks. A system of integrated, institutionwide limits and risk-taking guidelines should set boundaries for risk taking and ensure that positions exceeding predetermined levels receive prompt management attention. There should be global limits for each type of risk that are integrated with institutionwide limits on those risks as they arise in other activities, as well as limits that are allocable to individual business units.

Finally, risk management requires management evaluation and review. Banks with significant trading and derivatives activities should internally review methods of risk measurement at least annually. Internal evaluations may be supplemented by reviews by external auditors or consultants. Assumptions used to measure risk and limit exposures should be evaluated on a continual basis. Moreover, banks should have a formal process for the review of new products. Before a new product is traded, senior management, risk management, internal control, legal, accounting, auditing, and traders should understand it, develop appropriate policies and controls, and integrate the product into risk measurement and control systems.

Nontrading Activities Examiner Guidelines

Provisions on board of directors and senior management oversight. Active oversight of end-user derivatives activities by the board of directors and senior management of banks is also called for in the *Nontrading Activities Examiner Guidelines.* In general, the familiarity, technical knowledge, and awareness of directors and senior management should be commensurate with the level and nature of the bank's derivatives positions. Specifically, the board of directors should first approve and periodically review overall business strategies and significant risk-management policies, particularly policies on managerial oversight, risk tolerances, and exposure limits. The board also should actively monitor the bank's performance and risk profile and its derivatives portfolios. Minutes of the board's meetings should clearly demonstrate fulfillment of these responsibilities.

Second, directors should understand credit, market, and liquidity risks facing the bank as a whole and its derivatives positions in particular. If the directors do not have detailed technical knowledge of the risk-management process and risk exposures, they must ensure that they have access to independent legal and professional advice regarding the bank's derivatives holdings and strategies.

Third, senior management should ensure that there are adequate policies and procedures for conducting nontrading derivatives activities on a long-range and day-to-day basis. These policies and procedures include clear lines of authority and responsibility for acquiring instruments and managing risk, appropriate limits on risk taking, adequate systems for measuring risk, acceptable standards for valuing positions and measuring performance, effective internal controls, and a comprehensive risk reporting and management review process. To provide adequate oversight, management should understand fully the bank's risk profile, even when information and risk analyses are obtained from outside sources.

Fourth, banks with significant holdings of complex instruments should ensure that risk managers or risk-management functions are fully independent of those with authority to conduct transactions. Banks with less complex holdings should have a mechanism (in management or a board committee) for independent review of the level of, and process used in, managing resulting risks. In all banks, back-office, settlement, and transaction reconciliation responsibilities must be conducted and managed by personnel independent of those initiating risk-taking positions.

Provisions on written policies and procedures. Written policies and procedures should clearly outline the bank's approach to the management of end-user derivatives activities. Such policies should be consistent with the bank's broader business strategies, capital adequacy, technical expertise, and risk appetite, and should address the following areas:

- objectives (for example, generating earnings, hedging, or taking risk positions), at the portfolio and institutional levels, to guide acquisition of derivatives instruments and provide benchmarks for evaluating the bank's holdings, strategies, and programs;
- institutional risk tolerance, with a statement of authorized derivatives instruments and activities identifying objectives for their use, their permissible credit, and their market, and the liquidity risk characteristics of these instruments and portfolios consistent with the bank's overall risk limits (specified either as guidelines within overall policies or in management operating procedures);
- risk limits that implement overall risk tolerances and constraints;
- prior review by senior management and all relevant personnel of "new products" in which the bank intends to acquire a "meaningful position," as these terms are defined in the policies, and integration of such products into the bank's risk-measurement and control systems; and
- accounting treatment for derivatives holdings that is generally consistent with objectives and reporting requirements, and reflects the economic substance of off-balance-sheet derivatives transactions.

Provisions on risk measurement. The risk-measurement provisions of the *Nontrading Activities Examiner Guidelines* highlight that the failure of a bank that is an end user of derivatives to understand adequately the risks involved in its positions constitutes an unsafe and unsound banking practice, whether occurring due to lack of internal expertise or inadequate outside advice. Regardless of any responsibility, legal or otherwise, assumed by the dealer, a bank acting as an end user ultimately is responsible for understanding and managing risks posed by its derivatives transactions.

First, banks must conduct in-house preacquisition risk analyses or make use of specific third-party analyses that are independent of the seller or counterparty. Analyses provided by the originating dealer or counterparty should be used only when there is a clearly defined investment advisory relationship. Second, banks should obtain preacquisition price quotes and risk analyses from more than one dealer and, in doing so, assume that each party is dealing at arm's length for its own account, absent a written agreement to the contrary. As a generally sound practice, unless the dealer or counterparty is acting under a specific investment advisory relationship, banks should not enter into a transaction if its fair value or analyses required to assess its risk cannot be determined independently of the originating dealer or counterparty. Third, banks relying on third parties for market risk-measurement systems and analyses should ensure that they fully understand the techniques and assumptions used.

Other provisions of the Nontrading Activities Examiner Guidelines. The Appendix to the *Nontrading Activities Examiner Guidelines* highlights specific considerations in evaluating key elements of sound risk-management systems as they relate to credit, market, liquidity, operating, and legal risks associated with nontrading derivatives activities. Examiners are directed to (i) determine whether the bank's use of derivatives represents a prudent activity in light of the purposes for which they are used, management's ability to evaluate and control risks, and the capital positions of the institution; (ii) ensure that banks adopt adequate policies related to derivatives transactions and that all levels of management provide sufficient oversight of the risk-management process; and (iii) pay special attention to significant changes in the nature of derivatives instruments acquired, risk-measurement methodologies, limits, and internal controls, as well as in the earnings, size of positions, or VAR associated with derivatives activities.

Risk-Management Examiner Guidelines

Changes in the nature of the banking markets have made the risk-management process as important as the quality of the assets of a banking institution's balance sheet.

Active oversight by board of directors and senior management. First, the board of directors of an institution is ultimately responsible for the level of risk taken by that institution. The board of directors should approve all overall business strategies and significant policies for risk taking. The level of technical knowledge required by the board of directors may vary, based on the activities of the institution. If the institution engages in technically complex activities, the board of directors need not know the full details of the activities or the precise methods by which risks are

measured and controlled. The board of directors should, however, clearly understand the types of risk to which the institution is exposed and receive regular reports that detail the size and significance of the risks. On the other hand, if the institution engages in traditional and less complicated activities, the board of directors should be more involved in the day-to-day decision-making processes that determine risk taking.

Second, the board of directors should provide clear guidance on the acceptable level of risk exposure for the institution. The board of directors is also responsible for making sure that senior management follows this guidance.

Third, senior management is responsible for implementing strategies to limit risks and ensure compliance with all applicable laws and regulations. Senior management must possess sufficient knowledge of the major business lines of the institution to ensure that risk-management policies, controls, and systems are in place. It also must ensure that lines of authority and accountability are clearly delineated.

Fourth, examiners are directed to review the following:

- whether the board of directors and senior management have identified and understand the risks inherent in their institution's activities, and whether they have attempted to remain informed of potential risks from future developments;
- whether the board of directors has set up policies to limit the risks inherent in lending, investing, trading, trust and fiduciary, and other significant activities;
- whether the board of directors and senior management use adequate record keeping and reporting systems to measure and monitor major sources of risk;
- whether the board of directors periodically reviews and approves risk exposure limits in reaction to strategic changes, market conditions, or newly introduced products and activities, and whether all management responds to changing risks and market innovations that are relevant to the institution's activities;
- whether senior management ensures staffing by personnel with knowledge, experience, and expertise consistent with the nature and scope of the institution's activities, and ensures that employees have integrity and ethical values;
- whether senior management ensures that staff resources are adequate to operate and manage the institution's activities soundly;

- whether senior management identifies and reviews risks from new activities or products prior to authorizing them, to ensure that the current infrastructure and internal controls are adequate to manage the new risks; and
- whether all management provides day-to-day supervision of activities.

Adequate controls, procedures, and limits. First, the board of directors and senior management should tailor risk-management policies and procedures to the particular risks facing an institution. They should provide detailed guidance for daily implementation of business strategies and generally limit the institution's exposure to excessive or imprudent risks.

Second, the coverage and level of detail of the policies and procedures may vary based upon the size of the institution. Smaller and less complex institutions with effective and involved management need only have basic policies that address the significant areas of coverage with limited requirements and procedures. However, larger institutions with more complex business lines need to have more detailed policies.

Third, senior management must ensure that policies address areas of material risk and are modified as necessary.

Finally, examiners are directed to review the following:

- whether the policies, procedures, and prudential limits in place adequately identify, measure, monitor, and control risks arising from lending, investing, trading, trust and fiduciary, and other significant activities. Also, whether the policies and limits are consistent with the experience of management, the goals of the institution, and the institution's overall financial strength;
- whether policies clearly delineate lines of authority and accountability; and
- whether policies provide for prior review of new activities or products.

Adequate risk monitoring and management information systems. The board of directors and senior management must identify and measure all material risk exposures. Institutions must have information systems support that gives the board of directors and senior management timely reports on the financial condition, operating performance, and risk exposure of the consolidated institution. Line managers in charge of day-to-day management should receive detailed regular reports.

The sophistication of the risk monitoring and management systems should be consistent with the complexity and diversity of the institution's activities. Smaller institutions with less complicated activities only need a limited set of reports for the board of directors and senior management

that include daily or weekly balance sheets, income statements, troubled loan watch lists, past-due loan reports, sample interest rate reports, and other similar reports. On the other hand, larger institutions with more complex activities need more comprehensive reporting and monitoring systems for more frequent reporting, tighter monitoring of complex trading activities, and aggregation of consolidated risk for all activities. In addition, parent institutions that centrally manage subsidiary banks should have more comprehensive, detailed, and developed risk-management systems. Furthermore, all institutions must have systems that give the board of directors and senior management a clear understanding of the banking institution's positions and risk exposures.

Examiners are directed to review the following:

- whether an institution's risk-monitoring practices and reports address all material risks;
- whether ongoing reliability tests are conducted for key assumptions and data sources that are used in measuring and monitoring risks;
- whether generated reports are consistent with the institution's activities; whether they monitor risk exposure and compliance with relevant limits, goals, and objectives; and whether they compare expected performance with actual performance; and
- whether reports to the board of directors and senior management are timely, accurate, and sufficiently informative to identify adverse trends and adequately evaluate the risk level of the organization.

Adequate internal controls. Internal controls are critical to the safe and sound functioning of an institution's risk-management system. They are a fundamental and essential management function. They must be established and maintained, with enforcement of official lines of authority and separation of duties. Trading, custodial, and back-office booking functions must be strictly separated. Failure to separate functions can be an unsafe and unsound banking practice that may lead to losses and financially compromise the institution. Failure of separation also may warrant a supervisory action or formal enforcement action against the institution.

Internal controls should promote effective operations, and reliable financial and regulatory reporting, safeguard assets, and ensure compliance with appropriate laws, regulations, and policies. Institutions should have an independent internal auditor that tests internal controls and reports to the board of directors or a delegated audit committee. Institutions with small or traditional activities do not need a full-scale

audit but may engage in regular reviews of essential internal controls that are done by institution personnel. The reviewing personnel must be independent of the function being reviewed. All audits and reviews must be adequately documented with any management response.

With regard to internal controls, examiners are directed to look at the following:

- whether the system of internal controls is appropriate for the risks from the institution's activities;
- whether there are clear lines of authority and responsibility that ensure compliance with the institution's policies, procedures, and prudential limits;
- whether the lines of reporting are independent from the business areas, and whether there is a mandated and actual effective separation of duties between the trading, custodial, and back-office functions;
- whether there are accurate, timely, and reliable financial, operational, and regulatory reports, and whether exceptions noted in the reports are promptly investigated;
- whether there are procedures in place to ensure compliance with laws and regulations;
- whether the internal audit or control review is independent and objective;
- whether the review or test of internal controls and information systems is sufficient;
- whether there is adequate documentation of response to audits and high-level attention to material weaknesses and appropriate solutions implemented; and
- whether the board of directors and senior management regularly review the effectiveness of internal audits and control reviews.

Other guidance. The *Risk Management Examiner Guidelines* are intended to assist examiners in their evaluation of risk-management controls. Examiners are to give them considerable weight in their overall evaluation of an institution's management. The management rating will be an important factor in determining an institution's CAMEL supervisory rating.[15] Examiners are also directed to determine whether lack of risk-management oversight at an institution indicates a further level of noncompliance with safety and soundness regulations. Examiners will rate an institution's risk management on a five-point scale ranging from strong (1) to unsatisfactory (5).

Risk-Based Capital Guidelines for Interest Rate Risk

The Board of Governors, in conjunction with the OCC and FDIC, issued a final rule[16] that revises its risk-based capital guidelines for state member banks for better assessment of interest rate risk.[17] The final rule was promulgated under Section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),[18] which directed federal bank supervisors to revise risk-based capital standards to take into account banks' financial vulnerability to shifts in interest rates. The final rule revises the risk-based capital guidelines to include explicit consideration of banks' exposure to declines in the economic value of their capital due to changes in interest rates.[19] The guidelines help ensure that banks have sufficient capital on hand to cover potential losses incurred due to interest rate risk exposure. The final rule does not establish thresholds above which a bank's interest rate exposure is considered too high.

Risk-Based Capital Guidelines for Market Risk

The Board of Governors, in conjunction with the OCC and the FDIC, requested comment on a proposed amendment to its risk-based capital requirements that would incorporate measures for market risk arising from trading, foreign exchange, and commodity activities.[20] The Board of Governor's proposal applies to banks and bank holding companies with relatively large trading operations.[21] Under the proposal, banks could measure and contain market risk, which is risk from the possibility that market conditions may cause the price of an investment to vary, through the use of one of two different procedures.

The first procedure proposed by the Board of Governors owes it derivation to, but is different from, the Basle Committee's recently adopted procedures for determining capital standards for market risk.[22] This procedure would rely on a bank's internal models to ensure that sufficient capital is held to cover potential trading activity losses. This procedure uses standard parameters to calculate the VAR of a trading portfolio and then applies a multiplication factor to determine the amount of capital necessary to cover that portfolio.

The federal bank supervisors have issued a proposed amendment to their July 24, 1995 proposal to allow for internal model backtesting.[23] The amendment is based on a proposal by the Basle Committee on Banking Supervision published in January 1996,[24] and covers only large banks with significant trading activities. The proposal provides additional guidance to banking institutions on how backtesting results will be directly linked to an institution's potential capital charge.

Backtesting, which is comparing VAR amounts generated by internal models (institutions must use VAR amounts generated for internal risk-measurement purposes, not the daily VAR generated for supervisory capital purposes) against actual profits and losses on a daily basis, will be used to generate the multiplication factor used to calculate the market-risk capital requirements. The more inaccurate an institution's internal model is, the greater that institution's capital charge will be. This proposal is currently scheduled to be implemented by January 1999.

In contrast, the second procedure proposed by the Board of Governors, called the precommitment approach, would allow a bank to specify its desired level of capital to be held in reserve to support its trading activities. The bank would then commit to manage its trading activities so as to limit, over a specified interval, its market risk to the capital held. Should the bank fail to manage its market risk appropriately, penalties, such as civil fines, punitive capital charges, or supervisory sanctions, could be imposed. The Board has received public comments on its proposals and is reviewing the comments and the recent action by the Basle Committee.[25] The precommitment approach is being tested with a group of banks.

Risk-Based Capital Guidelines for Netting Bilateral Financial Contracts and Assessing the Credit Risk of Long-Term Financial Contracts

The Board of Governors, in conjunction with similar actions by the OCC and the FDIC, amended its risk-based capital guidelines for state member banks[26] and bank holding companies[27] to recognize in derivatives contracts the effects of netting arrangements in the calculation of potential future risk exposure, and to revise conversion factors used in estimating future credit exposure to recognize the differing credit risk among derivatives contracts with differing maturities.[28] Under the amendments, institutions are required to have reasoned legal opinions concluding that bilateral netting arrangements are legally enforceable in all relevant jurisdictions.[29] In many cases, the amendments may allow institutions using eligible derivatives contracts to hold less capital against future credit exposure.

Pursuant to the final revisions to the risk-based-capital guidelines, state member banks and bank holding companies may reduce the amount of risk-based capital that they are required to hold, through the use of bilateral netting arrangements, to offset future credit risk exposure.[30] These revisions are based on revisions to the Basle Capital Accord approved on April 10, 1995[31] and apply to future exposure of financial institutions to interest rate, exchange rate, commodities (including precious metals),

and equity contracts. The revisions also recognize the increased credit risk to institutions from derivatives with longer maturities by increasing the capital requirements on such contracts and revising the conversion factors used to estimate potential future credit exposure accordingly.

The Board of Governors adopted a final rule under which state member banks and bank holding companies may net positive and negative mark-to-market values of interest rate and exchange rate contracts subject to qualifying bilateral netting arrangements, in order to calculate a single current exposure for the netting contract.[32] The final rule is consistent with a revision to the Basle Capital Accord announced on July 15, 1994.[33]

Regulation EE

The Board of Governors adopted Regulation EE[34] to expand the application of the netting provisions of FDICIA[35] to a broader range of financial market participants and thereby provide further support for netting under U.S. law. FDICIA states that payment obligations for institutions covered by Regulation EE can be netted.[36] Regulation EE expands the coverage of FDICIA beyond netting contracts between and among depository institutions, federally regulated or supervised broker-dealers, and futures commission merchants to include all major derivatives dealers, including affiliates of broker-dealers and insurance companies.[37] Under Regulation EE, any legal entity would qualify as a financial institution for purposes of the provisions of FDICIA, protecting netting arrangements if it represents that it will engage in financial contracts as a counterparty on both sides of one or more financial markets and if it meets one of the quantitative thresholds in section 231.3(a) of Regulation EE. Representations by a counterparty may be made orally.[38] Thus, firms normally thought of as end users can qualify as dealers through Regulation EE's function test. If an end user carries out the functions of a dealer, it will receive the benefits of Regulation EE.

Regulation Q

On August 22, 1994, Board staff issued an opinion[39] that a transaction, in which a depository institution would enter into an off-market interest rate swap agreement with a demand deposit customer and in which the notional principal amount would be determined by reference to demand deposit balances, would involve a device for the payment of interest on a demand deposit in violation of Regulation Q. This regulation prohibits the payment of interest on demand deposits by regulated institutions, including U.S. branches and agencies of foreign banks with

worldwide consolidated assets in excess of $1 billion.[40] For purposes of Regulation Q, "interest" is "any payment to or for the account of any depositor as compensation for the use of funds constituting a deposit" excluding "absorption of expenses incident to providing a normal banking function" and "forbearance from charging a fee in connection with such a service. . . ."[41] Board staff concluded that any net payment of the bank to the customer under the swap would constitute a rebate that is a payment of interest prohibited by Regulation Q.

Office of the Comptroller of the Currency

Risk Management of Financial Derivatives: OCC Banking Circular No. 277

OCC Banking Circular No. 277 (Circular No. 277) is addressed to and provides guidance to national banks and federally licensed branches and agencies of foreign banks that engage in derivatives activities.[42]

Provisions on customer appropriateness.

- Senior management of banks that act as dealers of derivatives should establish procedures necessary to ensure that traders are able to identify instances in which a customer may not fully understand the risks associated with a particular transaction.
- Management must identify whether the proposed transaction is consistent with the counterparty's policies and procedures as they are known to the bank.
- Credit officers must analyze the effect of proposed derivatives activities on the financial condition of the counterparty.
- The bank must periodically update its assessment of the creditworthiness of the counterparty. The bank must implement a risk-management system that measures, monitors, and controls changes in the credit quality of counterparties.
- Credit officers must understand the applicability of derivatives to the risks that the customer is attempting to manage.
- When the bank believes a particular transaction may not be appropriate for a customer but the customer wishes to proceed, management should document its own analysis and the information provided to the customer.
- Before engaging in the transaction, the bank must "reasonably satisfy" itself that the counterparty has the legal and regulatory authority to proceed.

Provisions on netting agreements. The bank should reasonably satisfy itself that the terms of any contract governing derivatives activities are legally sound and consistent with regulatory authority. Banks should use master closeout netting agreements to the broadest extent legally enforceable, including in the event of the counterparty's insolvency. However, only when the bank has a high degree of certainty concerning enforceability should banks monitor their credit and liquidity risks and account for derivatives transactions on a net basis. Multilateral netting arrangements should be entered into only if cleared through a facility meeting the conditions set forth in the Lamfalussy Report.[43]

Provisions on board of directors and management oversight. The board of directors should approve of senior management's proposal to undertake derivatives activities. The board of directors or board-designated senior management should approve of new derivatives activities or significant changes in current activities, such as entry into a product line or market and use of derivatives instruments with different risk characteristics, for different purposes, or with cash flows dependent on markets in different geographic regions. Senior management should initiate and review at least annually policies and procedures that will apply to derivatives activities. The board of directors should initially endorse and periodically approve of significant policies and changes thereto. In addition, senior management should create an independent function to measure and report risk and monitor compliance. The risk monitoring unit should ensure that senior management and the board of directors receive information about credit exposure on a periodic basis.

Provisions on management and measurement of risk. Circular No. 277 offers specific guidance on market, credit, liquidity, operations, and system risk management and measurement. With respect to risk measurement, Circular No. 277 provides that a bank active in derivatives transactions should have a system to determine potential credit risk. Limited end users may rely on estimates of such risk from dealers or other third-party sources independent of the counterparty.

Provisions on hedging of physical commodities. A bank may engage in the hedging of physical commodity derivatives with physical commodities only under the following conditions:

- the commodities transactions supplement and constitute a nominal percentage of the bank's risk-management activities;
- the commodities transactions are used to hedge otherwise permissible customer-driven banking activities;
- the commodities transactions are not entered into for speculative purposes; and

- prior to entering into the commodities transactions, the bank's board of directors and the OCC have approved of a detailed plan for the hedging activity.

Derivatives transactions with respect to bank-eligible precious metals (gold, silver, and platinum) are not subject to this guideline.

Additional guidance. First, the OCC released additional guidance in the form of frequently asked questions about Circular No. 277.[44] Although not all types of derivatives are technically subject to Circular No. 277, because it focuses principally on over-the-counter (OTC) derivatives transactions, Circular No. 277 should be applied to all of a bank's risk-management activities, to the extent practicable. The OCC did not adopt a suitability standard for bank derivatives activities in Circular No. 277. The suitability guidelines in Circular No. 277 generally do not apply to a bank's transactions with other dealers or sophisticated market participants, nor do they require banks to request specific information or make a judgment about suitability before recommending a transaction. Rather, Circular No. 277 presumes, consistent with safe and sound banking practices, that a bank dealer will not recommend transactions it knows, or has reason to know, would be inappropriate for the customer on the basis of available information. Although a bank would not be prohibited from executing such a transaction, it must advise the customer of this determination, document it, and consider the customer's ability to perform the contract in making a credit decision. Furthermore, the OCC will require a legal opinion to support bilateral netting agreements for the purpose of calculating credit exposure with respect to transactions with many foreign counterparties, U.S. branches, or offices of some foreign counterparties. An industry legal opinion will satisfy this requirement, provided that the applicable standard agreement is used.

Second, the OCC issued an advisory letter to clarify and emphasize the duties national banks have to manage prudently their interest rate exposures.[45] National banks that have significant medium- and long-term positions should be especially careful to assess accurately the longer-term impact of changes in interest rates. Appropriate methods of measuring interest rate risk may range from gap reports (simple repricing reports) covering the full maturity range of the bank's activities to the economic value systems and simulation models. The goal of risk measurement should be to determine the direction and magnitude of exposure. The board of directors and senior management are responsible for understanding and controlling their institution's interest rate exposure. Risk tolerance should be clearly communicated and clear lines of responsibility established. Risk management should be implemented consistent with the national bank's level of exposure and its predicted exposure. Of par-

ticular concern to the OCC are instruments that contain an options feature, such as "the possibility of loan prepayments or the withdrawal of deposit funds."[46] Also of concern are such financial instruments as collateralized mortgage obligations, structured notes, credit card lines, indexed CDs, and off-balance-sheet derivative instruments.

Third, the OCC has released additional guidance in the form of frequently asked questions about AL 95–1.[47] Although the OCC still considers credit risk to be the most significant risk facing banks today, it believes that interest rate risk has grown due to changes in the structure of bank balance sheets and increased use of more complex products. The OCC is most concerned with long-term (length of over five years) products that contain embedded options. These products focus mostly on residential real estate and contain options that can be difficult to measure and control using customary short-term analysis. Embedded options associated with nonmaturity deposits and residential mortgages are very susceptible to changes in interest rates. Interest rate risk should be measured and evaluated by both the earnings and the economic perspectives. While the earnings perspective will show how interest rate changes will affect a bank's accrued or reported earnings, the economic perspective will show the potential impact of interest rate changes on the present value of the bank's future cash flows. The OCC expects all banks to understand the impact of interest rate changes on earnings, at a minimum. Banks with significant interest rate exposure should adopt VAR measurements as well as earnings-at-risk measurements. An economic value of equity calculation is not mandated but is recommended.

Fourth, the OCC has documented the compliance of many national banks that are active users of financial derivative instruments with Section C.1 of Circular No. 277.[48] Section C.1 imposes on national banks various duties by which they must determine whether a particular financial derivative instrument is appropriate for a customer. The OCC Sales Review lists the best practices that have been developed by national banks to comply with Section C.1.

Most national banks comply with Section C.1. No national banks have incurred major problems due to customer default, complaints, or lawsuits related to banks' compliance with Section C.1. National banks have used credit policies to comply with Section C.1. Credit officers implement the credit policies by developing an understanding of a customer's financial condition. Customers may be reluctant to provide necessary information. National banks evaluate customer appropriateness by developing a framework to understand a customer's needs for financial derivative instruments. This framework determines the appropriate level of involvement

for senior management, as well as the customer's sophistication and understanding of the transaction. In addition, national banks require appropriate written assurance that counterparties have all necessary authority to enter into the proposed transaction.

Finally, the OCC has published its examiner guidelines under Circular No. 277.[49]

Supervision by Risk

The OCC announced plans to implement a revised system under which its examiners will evaluate risk in national banks.[50] Under the new system called supervision by risk, OCC examiners will use newly defined, specific categories of risk to assess risk exposure. The goal of supervision by risk is to evaluate the quantity of risk exposure and determine the quality of risk-management systems in place to control that risk. The OCC will use risk as an organizing principle for all safety and soundness supervision.

Supervision by risk reflects a judgment by the OCC that risk assessment must be more fully and evenly incorporated into bank supervision. Therefore, the nine identified risks will be treated the same throughout all national banks, all products, and all activities. The nine identified risks are: (i) credit risk; (ii) interest rate risk; (iii) liquidity risk; (iv) price risk; (v) foreign exchange risk; (vi) transaction risk; (vii) compliance risk; (viii) strategic risk; and (ix) reputation risk. While different products or activities may create risk in more than one of these categories, the OCC feels that these nine identified risks are flexible enough to capture the present-day risk exposure of national banks.

Under supervision by risk, examiners will make and record judgments of risk exposure and the ability of the particular national bank to manage that risk exposure. Examiners will then prepare a summary that measures the national bank's aggregate risk judgment and determines the areas of potential future risk. This summary will help to focus future examinations on high-risk areas and limit examinations of low-risk areas. Examinations will no longer be focused by a transactional approach or an approach based upon product line.

The OCC implemented part of the supervision by risk program through its procedures for small (assets less than $250 million), non-complex community banks.[51] These procedures focus examiners on the most important risk for these banks, credit risk. However, the procedures also advise examiners to test the banks' trading activities and risk monitoring and management systems for interest rate risk.

The OCC has also released its examiner guidelines for large national banks.[52] Examiners are directed to employ a risk-assessment system under

which they will custom-tailor a risk profile to each institution under examination, weighing the quantity of risk against the quality of risk management. Ratings will be assigned for a bank's exposure to each of the nine risks and for its monitoring of the risks. Examiners will then determine an aggregate risk rating that indicates the direction of that bank's risk (growing versus ebbing). Examiners will use these ratings to focus future exams on specific problem areas.

Derivatives Guidance for Future Commission Merchants Activities

The OCC released News Release 95–122 (FCM Guidance) to provide guidance for examiners on derivatives instruments related to futures brokerage activities for bank subsidiaries acting as future commission merchants (FCMs).[53] The FCM Guidance outlines procedures for determining the adequacy of oversight of the FCM by the board of directors and senior management , and the parent institution's ability to monitor and manage various risks associated with futures activities. Highlights of the FCM Guidance are as follows:

- FCMs must have a unit for risk control and assessment that is separate from the derivatives trading unit and that reports its findings directly to the board of directors and senior management.
- The board of directors and senior management of the parent company should consider the interrelationship of the risks of the FCM subsidiary and the risks of other affiliates when establishing the FCM's risk limitations. The board of directors of the parent company should approve aggregate risk limits at least annually. These limits should relate directly to the nature of the parent company's strategies, historical performance, and overall level of earnings and risk-based capital. Capital directed to support FCM risk exposure should reflect the level and complexity of FCM risk, rather than the minimum regulatory requirements.
- Actions by the FCM directly impact the reputation risk faced by the parent company. The FCM's policies and procedures should be in line with the parent company's risk profile. Policies and procedures should include standards for disclosing risk to customers.
- The FCM should have at least one designated compliance officer.

Emerging Market Country Products and Trading Activities

The OCC released News Release 95–139 to provide guidance for examiners on derivatives instruments from emerging markets.[54] Banks should have written policies and procedures for emerging market activi-

ties for identifying, monitoring, and controlling risk, commensurate with their activity in those areas, and they should handle these activities in the same manner in which they treat other trading activities. Activities in these countries raise both specific country risk and interconnected risk from doing business in several emerging markets. The OCC has released the related examiner guidelines.[55]

Federal Deposit Insurance Corporation

The goal of FDIC guidance[56] is to ensure that appropriate capital levels, expertise, and management controls are maintained by insured institutions engaging in derivatives activities and off-balance-sheet activities in general. The guidelines focus, however, on the examination of institutions that are end users of derivatives. FDIC examiners review the risks associated with derivatives activities to determine whether a full examination of an institution's activities is necessary.

Provisions on customer appropriateness. First, regardless of any counterparty duties, institutions that are end users are responsible for fully understanding the derivative instruments and the attendant risks in a transaction. Such an end user has the duty to determine the suitability and appropriateness of its involvement with an activity. Second, institutions must have a testing process in place to ensure that counterparties have the necessary legal authorization to engage in a particular derivatives transaction and that individuals who enter into derivatives transactions for organizations are specifically authorized to do so. Even when standard netting agreements are used, there should be a legal review of the individual contract. Third, examiners should consider whether the institution has limited credit risk exposure by entering into transactions with financially strong counterparties.

Provisions on netting agreements. Legal opinions are required for netting agreements with foreign counterparties or when using unconventional netting agreements with any counterparty. A testing process should be in place for individual review of master netting agreements to determine enforceability in all relevant jurisdictions and in bankruptcy proceedings. Examiners should consider whether the institution has limited credit risk exposure by using bilateral closeout master netting agreements.

Provisions on board of directors and management oversight. The board of directors and senior management must be fully cognizant of derivatives strategies, the extent of current activities, and the attendant risks. Management should prepare, for review at meetings of the board of directors, documentation detailing the institution's planned involvement in derivatives activities and risk potential. Examiners should use the board of directors' meeting minutes and supporting documentation to measure

board involvement in and awareness of derivatives activities. Examiners should also look at management's ability to measure, monitor, and manage risk in all bank activities in order to determine management's handling of risks from derivatives activities.

Provisions on management and measurement of risk.

- Examiners should consider the type of instrument employed and the purpose behind the investment in determining risk exposure. Derivatives portfolios should be analyzed in the context of the related asset or liability positions of end users or the offsetting derivatives positions of dealers.
- Institutions that are significant users of derivatives should use a management reporting system that provides valuations for their entire portfolio and compares outstanding positions against risk and position limits. More sophisticated risk-management systems should include quantitative and qualitative assessments of scenario stress testing.
- Management reporting systems should include pricing data. The amount of data produced by institutions may vary in relation to the volume and purpose of the institution's derivatives activities.
- Dealers, active participants, and those trading for their own account should have internal pricing systems or another method for obtaining current market values. End users of only a limited number of contracts may rely on periodic prices provided by the dealer-counterparty. Institutions using derivatives solely for risk-management purposes may be able to rely on mark-to-market values provided by brokers. Institutions with substantial portfolios or those trading to take advantage of short-term price movements should update their mark-to-market positions frequently or establish market averages on a daily or intraday basis.
- Prior to the use of new products or entry into a new market, an institution should investigate the market, the number of market makers, the volume of transactions in the market, and the overall liquidity of the specific contract.

Provisions on scope of review. Examiners are directed to tailor their review of an institution to the intended use by the institution of the particular derivative product. Examiners should identify and review in detail institutions that appear to be speculating in derivatives contracts by taking unhedged or unmatched positions in anticipation that future price movements will be advantageous. Examiners should refer to reports, such as call reports and the Office of Capital Market's quarterly monitoring

report, to determine which banks experienced rapid growth in holdings or large positions as a percentage of capital or assets. On-site examinations will be more detailed in instances where management oversight and audit programs are less well developed.

Principles and Practices for Wholesale Financial Market Transactions and Enhanced Disclosure

Representatives from various financial trade groups, including the Emerging Markets Traders Association, the Foreign Exchange Committee of the Federal Reserve Bank of New York, the International Swaps and Derivatives Association, the New York Clearing House Association, the Public Securities Association, and the Securities Industry Association, joined together under the coordination of the Federal Reserve Bank of New York to prepare the Principles and Practices for Wholesale Financial Market Transactions (Principles).[57]

The Principles are proposed for voluntary adoption and implementation by participants in the OTC financial markets. The Principles are not intended to create or modify any legally enforceable obligations or duties. Rather, the purpose of the Principles is to define the relationship between participants in the OTC financial markets and to articulate a set of sound practices to be followed in connection with OTC financial market transactions between these participants. Participants in the OTC financial markets generally include financial institutions, institutional buyers, and other brokers, dealers, and end users that engage in significant and regular OTC financial market activities.

The provisions of the Principles include guidance on areas important to OTC trading activities, such as appropriate financial resources, internal policies and procedures, fair dealing and professional standards, risk-management considerations relating to relationships between participants, and the mechanics of the standards for OTC financial market transactions. The Principles affirm the arm's-length nature of OTC financial market transactions and encourage each participant either to seek independent financial advice or to enter into a written agreement defining the advisory nature of the relationship whenever a participant is unwilling or unable to take responsibility for its own decisions relating to OTC or financial market transactions.

Derivatives Policy Group's Framework for Voluntary Oversight

The Derivative Policy Group (DPG), which includes representatives of six broker-dealers with affiliates that are major OTC derivatives market

participants, with the cooperation of the Securities Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), released in March 1995 a voluntary framework for the OTC derivatives activities of unregulated securities firm affiliates of SEC-registered broker-dealers and CFTC-registered futures commission merchants.[58] The report, entitled *Framework for Voluntary Oversight*, notes that dealers generally have no affirmative disclosure obligations to their counterparties. The framework suggests that dealers should systematically disclose to new, nonprofessional counterparties the principal generic risks associated with OTC derivatives transactions.[59] The framework further notes that when a dealer becomes aware that a counterparty incorrectly believes that the dealer is acting in an advisory or fiduciary manner with respect to a prospective OTC derivatives transaction, it would be prudent for the dealer to clarify the nature of the transactional relationship. When dealers do provide materials such as valuations, quotations, or scenario analyses, the dealers should make a good faith effort to provide accurate materials.

The DPG has also proposed to develop a generic disclosure statement that is intended to address risks particular to OTC derivatives transactions and to clarify the nature of the counterparties' relationships. The statement would discuss the need for each counterparty to be aware of certain aspects of the market, credit, and pricing risks of OTC derivatives transactions. The Basle Committee on Banking Supervision report on the state of public disclosure of derivatives activities has cited the DPG's report and its implementation for the report's positive impact in the United States.[60] The SEC has also issued a proposal calling for further disclosure of information on derivatives activities relating to accounting policies, and quantitative and qualitative information on market risk.[61]

Federal Financial Institutions Examination Council

The Federal Financial Institutions Examination Council (FFIEC) has implemented its proposal[62] for the disclosure of additional information about off-balance-sheet derivatives in the commercial banks' consolidated reports of condition and income (call reports) of March 31, 1995. The required information involves further breakdowns of notional amounts of outstanding contracts by instrument type, by risk exposure underlying the contract, and by whether the contract is traded on an exchange or OTC. Requirements for reporting gross fair value data for derivatives also apply to banks with foreign offices or total assets of $100 million or more. The Board of Governors of the Federal Reserve System has approved consistent revisions to consolidated financial statements for bank holding companies.[63]

The FFIEC also announced that the use of new schedules to account for interest rate risk would be delayed.[64] At the same time, it announced that banks will be required in their March 1996 call reports to report on the results of their required internal capital analysis for Tier 1 capital and Tier 2 capital of total risk-based capital.[65] This change is designed to make the call reports more useful to end users. A new memo item was added to capture credit losses from derivatives contracts, whether they are charged directly to operating income or another account. Instructions were also added to require quicker accounting of replacement costs for derivatives counterparties in default.

Bank for International Settlements

The Group of Ten central bank governors have been considering a range of issues related to derivatives activities and market trading activities in general. The Committee on Banking Supervision (Committee) and the International Organization of Securities Commissions (IOSCO) each issued in July 1994 documents providing risk-management guidelines for derivatives to banks and securities firms and their supervisors.[66] The guidelines stress the importance of sound internal risk management by dealers and end users of derivatives instruments, with key elements including: (i) oversight by boards of directors and senior management through timely reporting under an independent risk-management function; (ii) a risk-management process involving prudent risk limits, sound measurement procedures and information systems, and continuous risk monitoring and reporting; and (iii) comprehensive internal controls and audit procedures.[67] The guidelines also present sound practices for the management of credit, market, liquidity, and operational and legal risks involved in derivatives activities.

A working group of the Eurocurrency Standing Committee of the Group of Ten central banks issued on September 29, 1994 a discussion paper on *Public Disclosure of Market and Credit Risks by Financial Intermediaries* (Fisher Report). The Fisher Report identifies as problematic the gap that has grown between the increasing precision with which a firm's management can assess financial risks posed by derivatives and other instruments, and the public information available to outsiders, including clients and shareholders, to evaluate the riskiness of the firm's activities.[68] The report states that this asymmetry in information leads to the inefficient allocation of capital, excessive fluctuation of asset prices, and possible increases in systemic risk.[69] To help close this gap, the Fisher Report recommends that all financial intermediaries, regulated and unregulated, periodically disclose to the public quantitative information already generated for internal risk-management purposes and provides examples illustrative of its recommendations.[70]

As a companion piece to the Fisher Report and to help shape the debate on public disclosure of quantitative information on market risk, the Federal Reserve Bank of New York issued a discussion paper, *Public Disclosure of Risks Related to Market Activity* (McCurdy Paper).[71] The McCurdy Paper proposes that financial and nonfinancial firms engaged extensively in market making or trading in derivatives or on-balance-sheet securities or both disclose associated risks in a statement separate from the balance sheet, income statement, and cash flow statement.[72] The new statement would include data on the firm's approach to risk management and control, market risk, credit risk, income, and risks related to options. The McCurdy Paper also proposes that end users disclose in a separate statement risks involved in their holdings of on- and off-balance-sheet financial instruments at levels of detail proportional to the amount of risk taken.

On December 11, 1995, the governors of the Group of Ten central banks endorsed a proposal by the Committee to amend the 1988 Basle Capital Accord to take account of market risk.[73] The proposal is intended to be implemented fully by bank supervisors by the end of 1997.[74] The Committee released a detailed supplement to the Capital Accord in January 1996.[75] The capital standards apply to market risks associated with foreign exchange, commodities, options, and trading activities (including trading in interest rate and equity derivatives) of internationally active banks. The amendment allows banks to choose between two methods with which to comply with market risk capital standards.

The first method is the standardized approach. Under this approach, bank supervisors prescribe procedures for measuring risk and calculating capital standards based on their own analysis, and banks are required to set aside appropriate amounts of capital to comply.

Under the second method, banks may use their own internal models to measure market risk and calculate regulatory capital requirements. The models-based approach builds on a measure of VAR and provides banks with flexibility on the general structure and detailed operations of their models. To use their own models, banks must meet certain quantitative standards to ensure that measures of market risk are sufficiently robust and consistent across institutions, as well as qualitative standards for their risk-management systems. Furthermore, banks must apply the multiple factor assigned by the Committee. The amendment lists the following qualitative standards that banks must meet:

- The board of directors and senior management must be actively involved in the risk-control process.
- There must be an independent risk-control unit.
- The model used must be integrated into day-to-day risk management.

- The model must involve vigorous stress testing.
- Banks must have a routine for ensuring compliance with documented internal controls and procedures.
- There must be regular independent reviews of risk management and measurement.
- Procedures should involve internal and external validation of the risk-measurement process.[76]

The amendment also lists the following quantitative standards that must be met:

- VAR computations must be done daily using a 99th percentile, one-tailed confidence interval.
- A minimum price shock holding period of 10 trading days must be used.
- Models must incorporate a historical observation period of at least one year.[77]

Once banks using the VAR method determine their capital at risk, they must translate it into a capital charge by multiplying it by the higher of (i) the previous day's VAR, or (ii) three times the average of the daily VAR of the preceding 60 business days. This charge is deemed necessary to provide a sufficient cushion for cumulative losses from extended adverse market conditions and is also designed to account for weaknesses in the model process. A bank also may be required to add a "plus" to its multiple factor based on how accurately its model is performing. If the model performs well, the plus will be zero. Therefore, banks have an incentive to develop and employ high-quality models.

Also adopted was a proposal to allow banks to recognize the correlation effects on risk not only within but across risk factor categories, so long as the appropriate bank supervisor approves the bank's system for measuring risk categories.[78] For example, banks may net risk from the drop in market value of one set of securities by the rise in market value of certain derivatives contracts. This move allows the diversification of trading activities, which acts to reduce risk.

The Committee released a supervisory framework in January 1996 describing the use of backtesting in determining capital charges for market risk.[79] This framework is similar to one proposed by the federal bank supervisors.[80]

On May 16, 1995, the Committee and the Technical Committee of IOSCO issued to bank and securities firm supervisors worldwide a joint

framework for supervisory information on the derivatives activities of banks and securities firms.[81] The proposal calls for improved access of supervisors to comprehensive and timely information, both qualitative and quantitative, on the OTC and exchange-traded derivatives activities of these institutions through various channels, such as on-site examinations, regulatory reports, special surveys, reports of external auditors, and regular discussions with firms' managements. It presents a broad catalog of data on derivatives activities in the areas of credit risk, liquidity risk, market risk, and earnings for supervisors to draw on as they expand their reporting systems, develop consistent approaches to evaluating derivatives risks, and discuss with institutions the types of information they should have available as part of overall risk management and control processes. The proposal also recommends that supervisors implement a common minimum framework designed to provide a baseline of information, primarily on credit risk, market liquidity risk, and overall market activity, for large, internationally active institutions with significant derivatives activities. The Committee intends to review the minimum framework in light of the current initiative of the Eurocurrency Standing Committee for the Group of Ten central banks to collect globally and on a regular basis aggregate statistics on OTC and exchange-traded derivatives activities of larger banks and securities firms.

On November 15, 1995, the Committee and the Technical Committee of IOSCO issued a joint report on the *Public Disclosure of the Trading and Derivatives Activities of Banks and Securities Firms*.[82] The report reviews disclosures made by select large international banks and securities firms in their 1994 annual reports, compares the disclosures with the same 1993 reports, and makes recommendations for further disclosure. In general, voluntary disclosure has improved. Several innovations recommended in the Fisher Report have been implemented, with the result of a greater dissemination of quantitative information on market and credit risks and associated risk management. Increased disclosure has contributed to a better public understanding of the risks and risk-management practices of leading banks and securities firms.

Benefits of enhanced disclosure included the creation of a foundation of information for the public and market participants. The report stated that institutions not providing information could be susceptible to market rumors in times of stress, resulting in a loss of counterparties, higher capital costs, and funding difficulties.[83]

The report makes several recommendations under which institutions should increase disclosure. First, institutions should better provide qualitative information that gives an overview of business objectives, risk-taking philosophy, and principle internal controls.

Second, institutions should provide better quantitative information on credit risk and market liquidity to give a clear picture of their overall involvement in the OTC and exchange derivatives markets. Market risk disclosure should use a VAR approach, although the report notes that, due to rapidly changing methods of measuring market risk, no current uniform standard is recommended.

Third, the report recommends that institutions continue to follow the Fisher Report approach, which states that banks and securities firms should draw from their own internal measurement systems when disclosing information on material risks. Such a procedure will lower costs while ensuring that disclosure keeps pace with risk-measurement innovations. The report also recommends that the common minimum framework from the May 16, 1995 report issued by the Committee and the Technical Committee of IOSCO[84] be used as a minimum standard for measuring the proper amount of information to disclose.

Other Significant Federal Initiatives

U.S. General Accounting Office Report to Congressional Requesters: Financial Derivatives: Actions Needed to Protect the Financial System

In *Financial Derivatives: Actions Needed to Protect the Financial System* (GAO Report),[85] the U.S. Government Accounting Office (GAO) made recommendations to Congress, the federal bank supervisory agencies, the Financial Accounting Standards Board, and the SEC to strengthen the regulation and supervision of derivatives activities. The GAO Report identifies the board of directors and senior management of institutions that participate in the derivatives market as primarily responsible for risk management, and cites the internal control and independent audit committee requirements of FDICIA[86] as a model to be applied to major U.S. OTC derivatives dealers. The GAO Report recommends that Congress require federal regulation of the safety and soundness of the major U.S. OTC derivatives dealers and suggests that the SEC be assigned responsibility for currently unregulated dealers.[87] It also emphasizes the need for consistency and comprehensiveness in the regulation of derivatives; calls for the development of comprehensive accounting rules for all financial instruments; and recommends that federal supervisors and regulators develop initiatives with industry representatives and regulators from other countries to harmonize disclosure, capital, legal, examination, and accounting standards for derivatives. Many of the GAO Report's recommendations are being addressed by supervisors and regulators in the form

of guidelines, pressure for increased disclosure and improved accounting measures, and initiatives for international coordination. A follow-up report of the GAO is expected.

Recommendations of the President's Working Group on Financial Markets

The President's Working Group on Financial Markets was reactivated in August 1993 to review the current state of supervision of derivatives activities. The Working Group consists of the chairs of the Federal Reserve, the SEC, the Treasury Department, and the CFTC.

The Working Group proposed an amendment to the U.S. Bankruptcy Code to clarify that spot foreign exchange agreements are included in the definition of "swap agreement" under the Code. The enacted amendment[88] provides for spot foreign exchange transactions the protections afforded forward and option foreign exchange transactions under the Code.[89] The Working Group will continue to consider such useful clarifications of current law.

The Working Group released an initial report on derivatives instruments on October 20, 1994.[90] The report outlines nearly 80 actions taken by federal supervisors and regulators during the prior two years to reduce risks that derivatives pose to the financial market. The report notes federal supervisory and regulatory initiatives directed at derivatives in areas including risk management, capital adequacy, accounting and disclosure, and the OTC markets. The Working Group concluded that, in light of these and other actions, the federal supervisors and regulators did not need new legislative authority to reduce risks of derivatives activities. Rather, the report notes that loss or failure is a necessary discipline for market efficiency and urges the federal supervisors and regulators to work with private market participants to ensure that a balance is struck between market discipline and governmental action. The Working Group will continue to evaluate the progress that the supervisors, regulators, and market participants have made and will consider whether further legislation is required.

COMMENT

TOBIAS M.C. ASSER

Financial Derivatives

The chapters on the topic of banks in distress provide ample evidence that the use of financial derivatives by banks raises important and difficult questions of prudential supervision. The collapse of Barings shows that leveraged derivatives trading, in combination with lax risk-management practices and inadequate prudential supervision, can bring down a financial institution.

Some chapters provide extensive information about the new methods and procedures for risk management by banks that were recently developed by bank regulators, including in particular the new "supervision by risk" system of the Office of the Comptroller of the Currency in the United States. Nevertheless, questions remain concerning the effectiveness of these new prudential systems in controlling risks and protecting banks from ruin, especially in extreme market conditions. The following comments address some of these questions in respect of leveraged derivatives trading by banks.

The term "leveraged derivatives trading" implies that it concerns banking activities that are speculative in nature, producing unhedged positions that are "leveraged." It should be assumed that leveraged derivatives trading occurs for a bank's own account and not for the account of its customers; in the latter case, the bank would not be exposed to risks deserving special attention.

These features of leveraged trading activities, namely, their speculative character and the fact that they are leveraged, cause these activities to pose risks for banks that differ from those posed by more traditional banking activities. Consequently, the risk-management methods and procedures that suffice for traditional banking activities are inadequate for leveraged derivatives trading. An example may illustrate this observation.

Traditional banking activities, such as taking deposits and making loans, expose banks to interest rate risk, namely, that the rate of interest payable on their deposit liabilities may exceed the rate of interest receivable on their loan assets. It follows that such traditional banking activities are particularly profitable in a stable interest rate environment.

Speculative trading, however, requires an interest rate environment that is volatile. For trading, interest rate volatility is not a risk but a necessity. Trading—successful trading that is—requires the ability to predict accurately the direction of short-term movements in asset prices. For the trader, the "risk" that actual price movements are contrary to his market predictions is not really a risk but rather a probability, an event that is expected by the trader to occur from time to time. In fact, many traders successfully use trading systems whose accuracy in predicting price directions is not much better than 50 percent. The profitability of these systems does not depend entirely on the traders' ability to make accurate market predictions but also and especially on their employing rigorous rules for the preservation of capital by limiting position size, cutting losses short while letting profits run, and adding to profitable positions. Although leveraged derivatives trading requires management of risk exposure in terms of value-at-risk, it equally requires sound trading techniques to generate profits and to avoid catastrophic losses. In this respect, the misfortune of Barings is instructive: the single most important reason for the Barings collapse was its failure to liquidate losing positions, requiring it to pay additional margin. Barings thereby violated the old futures traders' rule never to meet a margin call.[1] It is not clear that this major risk, namely, that traders do not adhere to proper trading strategies, is adequately reflected in the nine categories of risks that form part of the new U.S. system of bank supervision by risk.[2]

The term "leveraged" in leveraged derivatives trading implies that the value of the investment made to trade the derivatives is significantly less than the value of the assets underlying the derivatives traded. The following example may serve as an illustration. The contract size of a treasury bond future traded on the Chicago Board of Trade is $100,000. To open an unhedged position in this futures contract requires an original margin of $2,700 and a maintenance margin of $2,000. Accordingly, for an initial layout of $2,700, the trader of a T-bond future controls $100,000. Each price move of one point in treasury bonds translates into a premium move of about $1,000 for the T-bond futures contract. If the T-bond future is treated as an investment of $100,000, the price move would represent 1 percent of capital invested. If, however, the T-bond future is treated as an investment of $2,700, the price move would represent more than 37 percent of capital invested. It can easily be seen how such leveraged treatment of derivatives can produce spectacular gains and devastating losses. It seems obvious that, for purposes of measuring their risks, banks should be required to account for leveraged derivatives not at cost but at the value of the assets underlying the derivatives.

How effective is the new prudential approach to risk management in leveraged derivatives trading under extreme market conditions? The ref-

erence to extreme market conditions is of the essence. It seems logical to demand of a proper risk-management system that it protect primarily against catastrophic losses that cause ruin. To use an analogy: like an insurance policy, a proper risk-management system should provide protection against unsustainable losses, and need not (also) protect against losses that can be sustained and could therefore be excluded from the insurance cover as a deductible. Nevertheless, there are indications that the new risk-management systems are biased toward protecting a part of the risk spectrum that could be left uncovered because the losses that it produces are sustainable, while leaving the balance of the risk spectrum uncovered, even though this could produce losses that cause ruin. Such a bias would be counterintuitive and would require a careful justification.

For example, it appears that the new risk-management guidelines, adopted by the Basle Committee on Banking Supervision[3] and endorsed by the Group of Ten central bank governors in December 1995, measure value at risk with reference to historical price volatilities encountered during a specified period of time, taking into account a standard probability range. The selection of the length of this period and the range of probabilities is crucial. If the period over which volatilities are taken into account is too short, the system could fail to capture the ruinous volatility spikes that occur only at longer time intervals. The same would apply if the chosen probability range is too restrictive to include catastrophic events.[4] There are reasons to fear that the Basle risk-management guidelines would be least effective in the extreme market conditions where their effectiveness would be most needed.

These observations have been countered with the argument that it would be too expensive for banks to cover the entire spectrum of risks to which they are exposed as a result of leveraged derivatives trading and that it is the function of a country's monetary authorities, as lenders of last resort, to protect the banking system from ruin in exceptional circumstances. Although this counterpoint is not altogether unreasonable, it could transfer the ultimate costs of leveraged derivatives trading by banks onto the shoulders of the taxpayer. This unpopular prospect leads to the provocative question of whether banks should be permitted to engage in leveraged derivatives trading at all.

Hypotheticals

1. Should depository institutions be permitted to maintain speculative (that is, unhedged) positions in derivatives for their own account?

2. If so, should depository institutions be required to observe limits set by law or regulation on the speculative positions in derivatives that they maintain for their own account?

COMMENT

DOUGLAS E. HARRIS

Introduction

The answer to the question of whether derivatives are speculative instruments or whether they are useful risk-management tools depends on how they are used and for what purpose. There is no doubt that many investors take financial positions in a manner that reflects their views about potential market changes. In some instances, this may be viewed as prudent risk management; however, such positioning can also be speculative. To say, therefore, that derivatives should be prohibited simply because they can be used for speculative purposes is an anomaly for many financial institutions that are involved in a number of risk-taking activities, one of the biggest of which is lending their money to others. One of the things that the Office of the Comptroller of the Currency (OCC) has found by tracking the exposures—specifically, credit exposure—of some of the largest banks is that, as large as derivatives activities have grown, the exposure on credit card loans was much greater than the exposure from derivatives. Nevertheless, derivatives are generally perceived as very risky. The revenues that flow from derivatives are volatile, but, in fact, the greater risk—and thus the potential for greater loss—is still associated with lending out a bank's own money.

To put this in perspective, some derivatives have been designed specifically to hedge risk—witness the growth and development of the futures markets. These markets started out as places where farmers could hedge their exposure to rising and falling grain prices, and they were used successfully for that purpose for years. Currently, you can also trade in foreign currency futures, treasury bond futures, insurance futures, and other catastrophe futures. However, one reason these markets work is because some investors come to the markets specifically to speculate. They are not wrongdoers. In fact, speculators are needed to provide liquidity to the markets so as to allow those investors that need to hedge the ability to do so. Without speculators providing liquidity to the markets, there are no markets. However, by their very nature, speculators generally take one-sided financial exposures—that is, they are betting that a particular market change will occur. As a consequence of their activities, their risk profiles tend to reflect higher risk exposures. In order to mitigate the potential risk speculators might pose to the markets, there are restrictions on the markets and the way the markets operate.

Other types of derivative contracts can provide substantial benefits for risk management, but they can also pose material amounts of risk. As a result, the OCC expects that the institutions that it supervises should implement comprehensive risk management and control practices commensurate with the level and extent of their activities.

There is absolutely no doubt that derivatives have had a profound effect on the way that banks conduct their business. In addition, they also have had a profound effect on the way the OCC supervises banks. Much attention has been focused on derivatives, primarily because they are new products and also because of their perceived risk. While some derivatives, as previously noted, are no more risky than lending one's own money, particular derivatives can be extremely risky, as evidenced over the past few years. However, individually and collectively, both the banks and the regulatory agencies have come to the conclusion that it is the risk, and not necessarily the specific product, that should be the focus of concern. The risk matters, and it is the risk that needs to be controlled. One of the first ways in which bank supervisors started to address this risk was through capital standards. Bank supervisors have now gone further to address risk management and internal controls, as well.

Although there are certain procedures and practices that should be uniform and applied to most financial institutions, the OCC found that any attempt to make these risk-management principles invariable almost amounts to micromanagement, which would ultimately be a mistake. The risk-management procedures, or risk-management principles, that banks use to manage risk are changing constantly. Therefore, the whole area calls for a flexible approach to supervision. With a few qualified exceptions, the OCC, as well as the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation (FDIC), have issued only guidance and advisories in the area of derivatives and risk management. Inflexible rules and regulations have not been issued. The following are some examples of the guidance and advisories that have been released.

OCC Guidance and Advisories

One of the first things that the OCC did to address the supervisory issues that arose in connection with bank derivatives was to issue Banking Circular No. 277, *Risk Management of Financial Derivatives* (BC-277).[1] BC-277 provided basic guidance on how banks should identify, measure, monitor, and control the risks arising out of their derivatives activities, whether the banks were acting as dealers, active position takers, or limited end users. Although the title is *Risk Management of Financial*

Derivatives, it is clear from the document that it was not meant to be limited to derivatives. The guidance itself can be applied as broadly as possible to a bank's risk-taking activities. This is a significant point that will be addressed again. BC-277 was followed with a set of questions and answers that clarified and provided further guidance on some of the issues addressed in the circular.[2] In the summer of 1994, the OCC issued an Advisory on Structured Notes,[3] which was one of the few examples of a situation in which the OCC actually focused on a specific product. However, even here, the OCC's focus was on the risk. The OCC cautioned banks, especially the smaller banks, that there could be significant market and liquidity risks associated with some forms of structured notes. At that time, there was an interest rate spike in this country, and many small banks were discovering for the first time that the structured notes that they had purchased—which seemed to be so valuable and initially offered them such high rates of return (over what was otherwise available in the market)—were in fact depreciating rapidly in value. What those banks and many market participants had not focused on were the substantial market and liquidity risks associated with the notes because of the way they were structured, even though most of these notes were being issued by the most creditworthy borrowers.

In the fall of 1994, the OCC issued nearly 100 pages of detailed guidance to its examiners on how they should determine whether a bank is complying with BC-277.[4] In early 1995, the OCC issued an advisory on the measurement, monitoring, and control of interest rate risk.[5] Specifically, the OCC cautioned banks, many of whom had already moved away from a simple gap analysis to an earnings-at-risk analysis, that neither of these analyses may be sufficient to monitor adequately and control their interest rate risk, especially at those institutions with substantial medium- and long-term exposures. The OCC suggested that banks should consider whether the addition of a value-at-risk model to their risk-management arsenal would be appropriate.

In November 1995, the OCC issued guidance to its examiners on examining futures brokerage subsidiaries.[6] Those are the entities that broker exchange-traded futures and options for clients. This is an activity that U.S. banks first became involved in during the early 1980s, and it is one that has grown. It is clear that the OCC's interest in providing guidance—even though the OCC supervises only a handful of banks that have these subsidiaries—was brought on by the Barings incident. Although it was Barings, the bank, that collapsed, the problems were located in its futures brokerage subsidiary in the Far East. The OCC wanted to ensure that the proper management and control of risk existed in such subsidiaries for national banks, so that the risks in these subsidiaries would be well contained and would not necessarily be transferred

to the parent bank. In fact, the OCC specifically commented on the fact that there are substantial liquidity risks and transaction risks associated with futures brokerage activities.

In December 1995, the OCC issued guidance on emerging markets activities.[7] The OCC cautioned banks about the substantial liquidity risk and sovereign risk associated with emerging markets activities.

In May 1996, the OCC issued a bulletin providing guidance as to how banks should manage the risk arising out of their fiduciary activities, specifically, investing in derivatives in a fiduciary capacity.[8] In this instance, the OCC was specifically concerned with investments in structured notes and collateralized mortgage securities. It is clear that some of these derivatives were being acquired for investment purposes. There was no semblance of hedging. Rather, they were viewed as investment substitutes and, as such, were being acquired for "speculative purposes" to achieve a high investment return. In many cases, as the OCC found with structured notes a couple of years ago, some of the fiduciary accounts were beginning to suffer losses as a result of these investments.

Providing guidance to banks on proper risk management of various products and activities has caused the OCC to change its initial approach and, in this connection, to rethink how it examines and supervises banks. As described in Chapter 10A, in early 1996 the OCC unveiled a new supervisory program called "Supervision by Risk." Under this new program, OCC examiners make an assessment of the quantity and quality of risk management at individual banks, and then the OCC allocates its supervisory resources accordingly. One of the first steps in developing this approach was to come to an agreement on a common lexicon of risk. The OCC came up with nine categories: credit risk, interest rate risk, liquidity risk, price risk, foreign exchange risk, transaction risk, compliance risk, strategic risk, and reputation risk. One important risk that is probably subsumed in a couple of these risks is intellectual risk. Although the OCC has not specifically identified intellectual risk in its lexicon of risks, it is something the OCC takes seriously in risk management, especially for capital markets activities.

One part of intellectual risk relates to the concentration of knowledge that may exist on the trading floor and the risk that this concentrated knowledge may move to a competitor. Another element of intellectual risk is the gap in knowledge that can exist in an institution. While there may be a concentration of knowledge down on the trading floor with respect to specific innovative products and activities, there may nevertheless be a gap between the knowledge of the traders and the amount of knowledge about those same products and activities that is held by senior management. The OCC believes this to be a big problem. Ultimately, it

is senior management that has the responsibility for ensuring that proper risk-management procedures are in place and that they are being followed. Both ensuring that risk-management procedures are appropriate and ensuring that they are being properly implemented depend upon having an understanding of the product and the activity. Such knowledge gaps often arise with respect to capital markets activities because senior management in many institutions is very often drawn from the corporate lending side of the business. However, those on the trading floor are often younger and do not have the same level of experience and capacity for judgment that senior management has.

Depending heavily on experience and good judgment, the last two of the OCC's nine risks—strategic risk and reputation risk—are in a somewhat different category from the first seven. The first seven are more quantifiable. Strategic risk and reputation risk are somewhat soft in terms of the institution's consistent and recognized ability for good decision making. This can be difficult, if not impossible, to quantify. Yet, the recent Bankers Trust case is evidence of the high degree of reputation risk involved in derivatives trading.[9]

The OCC's program of supervision by risk is certainly the right approach. The Federal Reserve and the FDIC have similar programs. Risk can serve as a common denominator to provide a consistent way of analyzing potential effects on earnings or capital across a variety of bank products and activities. Bank supervisors need to be concerned about the overall quality of a bank's assets. In other words, it is important not to lose sight of the combined effects of the separate categories of risk. Different types of risk are not necessarily independent. Bank supervisors could miss significant problems if they only focus on whether or not individual risks are being managed and controlled.

Sales Practices

There has been much work in the area of sales practices at the OCC. Sales practices were first addressed when BC-277 was developed, but they were addressed in a different way from the risk-management perspective of a bank. Two concepts are relevant: "appropriateness" and "suitability." Appropriateness describes an effective way for a bank to manage and control its credit risk, litigation risk, and reputation risk. It requires the bank to make an assessment, prior to engaging in a derivative transaction, as to whether the transaction is consistent with its counterparty's policies and procedures for engaging in such transactions. The term suitability is associated with the duty that one party has to the other party to ensure that the obligation is a suitable obligation for that counterparty, where suit-

able means consistent with its financial resources, its expertise, and its knowledge. The OCC's appropriateness standard is more limited than the suitability standard. The former is concerned only with whether a transaction is consistent with the counterparty's policies and procedures. It is primarily designed to protect the bank; however, it can serve to provide indirect protection for bank customers as well.

Bank regulators in the United States have also recently proposed for adoption a suitability standard with respect to government securities.[10] It is essentially the same interpretation that the National Association of Securities Dealers has set forth under the Government Securities Act, which provides a carveout for certain institutional customers.[11] This is noteworthy because government securities include not only U.S. treasury bonds, notes, and bills, but also most structured notes, inasmuch as many of these are commonly issued by government-sponsored enterprises. It is thus possible that bank supervisors are starting down the slippery slope of making dealers more legally obligated for the mistakes of their counterparties. Hopefully, they will know where to draw the line. In May 1996, a judge decided in Procter & Gamble's case against Bankers Trust that Procter & Gamble was a sophisticated counterparty and that the transactions in question were made at arm's length.[12] For the near term, it is relevant to consider whether actions that regulators have taken to implement the Government Securities Act Amendments of 1993[13] are inconsistent with the Procter & Gamble ruling or, for that matter, with the *Principles and Practices for Wholesale Financial Market Transactions*, which was recently developed by several financial market trade associations.[14]

Chapter
17 International Law of Bank Secrecy

PHILIP R. WOOD[1]

Introduction

In civilized societies, the privacy of individuals is a fundamental policy. So also is the protection of the individual. As always, these policies of private freedom and public submission are not easy to balance.

Special secrecy codes apply to those people to whom individuals must of necessity disclose their private affairs—priests, doctors, accountants, and lawyers. These custodians of confidentiality would not be able to minister their aid if they did not guarantee the secrecy trust confided in them. The secrecy codes are sometimes extended to those people who handle private assets—stockbrokers and banks. To the extent appropriate, the privileges benefit corporations.

Nearly all countries with developed legal systems respect bank secrecy. The differences between the countries are of degree rather than substance. There is little divergence on the rule that a bank may not disclose information on its customers to other private persons. However, there is significant divergence on the degree to which banks must disclose such information to government authorities.

The main debate, therefore, centers on the extent to which the country should have direct access to information kept by banks about its citizens or the citizens of another country. However, this is not by any means the only debate.

Banks traditionally respect the confidence reposed in them as a matter of sound business policy. The law of bank secrecy is primarily concerned with compulsory disclosure. Deliberate intrusion by others receives less protection, but is controlled to some degree in some countries, for example, by (i) the tort or delict of wrongful invasion of privacy (for example, excessive intrusion by journalists) and (ii) controls on wire-tapping and other surveillance. The right to inspect and check the accuracy of personal data kept by credit data bureaus is a separate topic and is covered in many countries by specific legislation designed to protect the individual against secret files containing wrong facts.

The objective of this chapter is to attempt a summary description of international attitudes on bank secrecy and disclosure, and to indicate some of the policies that may have influenced the divergent attitudes of jurisdictions. This chapter does not make recommendations, because countries will have different policy objectives; however, it does provide information about the international experience.

Motives for Bank Secrecy

Banks are the custodians of the people's means of exchange. It is now virtually impossible to carry out financial dealings otherwise than through the intermediary of banks. The use of banks is a necessity. Banks are therefore the repositories of immense information about their customers. Some of the customers will be good, some average, and some bad. Knowledge is power. Apart from this, there are many motives behind the desire for privacy.

In the case of individuals, there is often a general desire to maintain the privacy of one's own economic dealings. Wealthier individuals may desire not to disclose wealth to children, spouses, family, or heirs, and wish not to attract the attention of thieves and rogues.

Businesses may wish to protect themselves from competitors and will seek to keep confidential information regarding pricing, future plans and strategies, inventions (until protected by patents), and their financial condition.

Some "flight capital" is money transferred abroad to protect it from political and economic storms, for example, expropriations, overrestrictive exchange controls, excessive taxation, discriminatory takings, and runaway inflation. Switzerland has historically offered a safe refuge against foreign tumult in such cases, involving the Huguenots during one century and the Nazis in another. Other flight capital seeks a hidden refuge from mere ordinary taxation and exchange controls. Bank secrecy may be abused by corrupt persons seeking to conceal the proceeds of their wrongdoing.

Apart from the upholding of the law, legislatures seek to balance several interests in their banking policy. First, some desire to encourage savings in banks, domestic or foreign, and, therefore, consider that secrecy must be guaranteed. Countries that have nationalized banks may particularly emphasize the secrecy duty in order to counter fears of leakages of information to the country as owner. Second, some legislatures desire to preserve the banking system—which rests on confidence and reputation—from the taint and the odor of impropriety. The banking system could be jeopardized if the public loses trust in its integrity. For this rea-

son, among others, bank licensing systems commonly require high standards of management integrity and compliance with the law. Sometimes the transparency needed to combat fraud, and thereby to foster public confidence, may conflict with the privacy needed to foster that same public confidence.

Compulsory Disclosure Overriding Bank Secrecy

The main reasons for piercing the veil of secrecy include:

- the prevention of serious crime (fraud, theft, bribery, and drugs);
- the prevention of evasion of economic law (exchange control, trade and customs, and antitrust laws);
- corporate disclosure and transparent securities markets (audited accounts, prospectus disclosure, false markets, and insider trading);
- corporate governance (inspections);
- the supervision of banks by regulatory authorities;
- the supervision of securities dealers and investment advisers;
- civil litigation (discovery of evidence and pre- and postjudgment attachments); and
- insolvency (collection of assets, director liability, fraudulent preferences, and wrongdoing).

Other miscellaneous exceptions are listed in this chapter.

International Collisions

The generally accepted international view is that a country cannot enforce its national laws on the territory of another country without the consent of the latter. Hence, a country cannot carry out a police or tax investigation, compulsorily interview a witness, search premises, serve a summons, arrest an accused, or order the production of documents on the territory of another country, unless the latter has consented, for example, by its own statute or by a treaty. There are many erosions of this principle in national practice.

International "collisions" on bank secrecy result from:

- different views about the ambit of jurisdictional sovereignty;
- differences of opinion as to the interests that should be protected, for example, individual against country, private against public, tolerance of some fraud in the interests of some other higher public

objective, liberal against stringent regulation, intensity of economic laws (exchange control, customs, or antitrust laws), or encouraging the public to use the banking system;

- differences springing from inertia in the legal system: some countries are more preoccupied with survival against hunger and with the dread of anarchy than sophisticated laws dealing with bank disclosure;
- differences of opinion as to the extent to which banks should be involved in law enforcement; and
- an indulgent attitude by some countries toward flight capital escaping extremely adverse local conditions: some countries consider it reasonable to provide a banking haven against foreign oppression, economic anarchy, or gross mismanagement.

The dismantling of exchange controls in many countries has exacerbated free flows of funds out of some countries and, in particular, weakened the ability of tax authorities to prevent leakages.

Distinctions should be made among the following areas:

- serious foreign crimes. (Cooperation is extensive because countries agree on serious criminal conduct and have a mutual interest. Traditional barriers based on national sovereignty are being rapidly dismantled.)
- regulation of "public interest" enterprises, such as banks, investment firms, insurers, and securities firms. (Cooperation is widening quickly.)
- the prevention of tax evasion. (Cooperation is controversial in many countries.)
- economic laws. (Cooperation has traditionally been quite limited in this case; for example, exchange control, antitrust—competition, monopolies, restrictive trade practices—customs, rationing, import or export control laws.)
- private civil litigation. (Cooperation is patchy but expanding in the case of civil fraud and tracing claims.)

Because of the emphasis on country consent to mutual assistance, there is an increasing proliferation of treaties that seek by consensus to avoid confrontations. There is also a significant measure of harmonization of laws in this field that reduces the risk of collision, notably in the case of bank supervision and money laundering. These trends are documented later in this chapter.

European Union: An International Effort

The European Union (EU) is notable for measures taken to pierce banking secrecy at the international level. There are at least two reasons for this. First, the concept of a single international market requires a harmonized secrecy and disclosure duty for financial transactions. Second, because only one authorization is required to trade in any of the member states, the "single passport," bank secrecy needs to be synchronized, and regulatory authorities need to be able to exchange information. This practice is stretched to include exchanges of tax information. Not all member states wholly share the view that information should be freely exchanged for bank supervision purposes. Austria, Greece, Luxembourg, and Portugal have tight secrecy laws compared to other member states. Bank secrecy is only one of the areas where the idea of the unitary country conflicts with autonomy.

Classification of Jurisdictions

A classification of jurisdictions is unsafe because, among other things, detailed data are difficult to collect and then evaluate accurately, and countries may be lax in one area of disclosure but not another so that a weighting has to be applied, which is bound to be subjective. Nevertheless, one may very tentatively classify the jurisdictions as follows:

Low Secrecy	United States
Medium Secrecy	Australia, Britain, Canada, Ireland, Italy, Japan, Jersey, numerous other Commonwealth countries including India, Malaysia, and Singapore, and the Scandinavian countries
Quite High Secrecy	Denmark, France, and Germany
High Secrecy	Austria, Greece, Liechtenstein, Luxembourg, Portugal, and Switzerland (some cantons only)

Special tax haven jurisdictions (for example, those in the Caribbean and Pacific) are excluded from this list. The author has not investigated most South American countries. Many African countries probably have basic legal regimes based more or less on those of former imperial powers, although divergence is becoming increasingly pronounced. Perhaps some countries in the Middle East (for example, Egypt, Kuwait, Lebanon, and the United Arab Emirates) might have been influenced by French ideas because their codes are Napoleonic based. It is not easy to ascertain

trends in the new legislation in Central and Eastern Europe, Russia, the other countries of the former Soviet Union, or in emerging countries in Asia, because legislative development is rapid.

Generally, most of the world's 300-plus jurisdictions can be put into seven or eight groups, insofar as their financial law is concerned.[2] Apart from the Romans, the main suppliers of commercial and financial law to the world have been: England, France, Germany, the Netherlands, Switzerland, and the United States, probably in that order. The inheritance of law may facilitate a grouping of basic approaches, for example, in relation to the criminalization of bank secrecy or disclosure in civil litigation. However, bank secrecy is vitally affected by national economic policies and by the take-up of multilateral and bilateral treaties. In these areas, national laws are influenced more by particular local policies than by the norms of a received legal system.

Sources of Law for Scope of the Secrecy Duty

Sources of Law

The basic duty of secrecy is contained in case law, codes, or special statutes. The method of writing down the law is immaterial; what the law says is much more important. In some countries (for example, Germany, Japan, and the Netherlands), the law is contained in general contract terms. These are unusual in common law countries, but in those having standard-form, industrywide general conditions, there has been a recent proliferation of banking codes of good conduct promoted by bank associations, among which is that of the United Kingdom.[3] Special confidentiality contracts, for example, in relation to project finance deals (important to project sponsors), are used to provide bank secrecy. These are contracts between participating banks, the project sponsors, and the project company. They cover the credit documents and information acquired by participating banks in connection with the credit. Typical express exceptions allow disclosure in the case of (i) consent; (ii) bank officers, employees, and advisers who need to know; (iii) grant of participations; (iv) public domain (otherwise than by breach of the duty); (v) compulsion, for example, in the case of supervisory request or court orders; (vi) event of default and bank enforcement; (vii) securities regulation; and (viii) audit. These confidentiality clauses are an interesting mirror of secrecy statutes. Many such contracts require the bank to notify the customer of disclosure requests from the authorities (if permitted) and to give the customer the maximum opportunity to object.

Non-legally-binding guidelines or codes of practice (so-called soft laws) approved by bank associations are another source.[4] New Zealand has a voluntary *Code of Banking Practice,* which was originally published in 1992 by the New Zealand Bankers' Association.[5] This code adopts the *Tournier* rules about confidentiality.[6]

The final source of law on the duty of secrecy is ultrasoft administrative law, that is, unofficial policies set by club consensus and encouraged by bank regulatory authorities, especially to control crime. A decreasing number of countries prefer the "soft law" option to hard "black-letter" statutory regulation.

Relevance of Categorization

The importance of categorizing, whether the duty of secrecy springs from contract, tort (delict), or domestic statute, affects issues regarding the governing law and how it is ascertained, if there is no express choice; judicial jurisdiction; remedies; provability of damage claims for breach of the secrecy duty in insolvency proceedings; the rights of the citizen, for example, if the statute is constitutional or falls within the province of administrative law; and various technical matters, such as interest on damages, security for costs, and limitation of actions (prescription).

In practice, problems on these points seem to be few. Where the duty is contractual, liability is usually strict, the contract must be performed, and there is no question of having to prove negligence.

English-Based Jurisdictions and Implied Contractual Terms

In a large number of countries with English-based legislation—of which there are at least 80 jurisdictions—secrecy is a term of the contract implied by custom. The foundation case is *Tournier v. National Provincial and Union Bank of England.*[7] Mr. Tournier had no fixed address, so he gave his bankers the address of his employers. He defaulted on a bank loan of £10. The bank told his employers and informed them that Tournier was betting heavily. The employers sacked him. The court held that banks are under a duty of confidentiality. The Court of Appeal defined the duty and its exceptions, namely disclosure in the case of (i) compulsion of law; (ii) duty to the public to disclose; (iii) required in the interests of the bank; and (iv) express or implied consent of the customer. This case is the basis of the law, among other countries, in Australia, the nine Canadian common law provinces (in Quebec there is thought to be a similar customary rule), Hong Kong, Ireland, New Zealand, and Pakistan (codified in 1974 for Pakistan nationalized banks). The laws of a few of these are noted below.

In the United States, the scope of the secrecy duty varies from country to country, but resort to the principles in *Tournier* appears common. In *Peterson v. Idaho First National Bank*,[8] a bank told the customer's employer that the checks of the customer had been returned for insufficient funds. The court held that the bank was in breach of an implied contract of secrecy. In *Milohnich v. First National Bank of Miami Springs*,[9] the bank disclosed to third parties the amount the customer had on account. The third parties used the information to obtain court orders to freeze the account. It was held that the bank had a duty of secrecy.

Implied Contractual Terms in Other Jurisdictions

Numerous other jurisdictions share the English view that bank secrecy is an implied contractual term arising from custom and not needing express mention. This view prevails in Belgium, Germany (the majority opinion), Italy, Japan, the Netherlands, Spain, and Sweden. In none of these jurisdiction is there an express statute on bank secrecy. In several of them, there is much theorizing as to whether the duty might sometime arise in the law of tort or delict.

Penal Code Provisions in Some Napoleonic Jurisdictions

Nearly 80 jurisdictions either directly borrowed the original French codes or were influenced by them. The latest country to borrow France's codes is the United Arab Emirates in the 1990s, probably through the examples of Egypt and Kuwait.

Article 378 of the 1810 French Penal Code imposed criminal sanctions on persons such as physicians and "all other persons who are in possession, by virtue of their . . . profession . . . of secrets confided to them" who reveal those secrets.[10] Because there was doubt in France as to whether this criminal sanction applied to banks or whether the duty was merely civil and customary, it is not surprising that receiving countries should go either way on this issue. Thus, this provision has been held to apply to banks in Luxembourg[11] but not in Belgium. In France, the position was clarified by a statute in 1984[12] so that doubts about the application of the Penal Code to banks were put to rest. A breach of the secrecy duty was expressly criminalized.

Codification of Implied Terms

In many countries, bank secrecy is codified. New codifications are common in central and eastern European countries and the Asian republics of the former Soviet Union, for example, Kazakhstan, which do not feel safe

in assuming a customary rule. For example, in the Czech Republic the duty is contained in Section 38 of the Banking Act.[13] Breach is noncriminal but gives rise to claim for damages and, no doubt, possible sanctions by the central bank. There are the usual exceptions in favor of (i) the bank supervisory authorities, (ii) court orders for the purposes of civil law proceedings, (iii) an authority engaged in criminal proceedings under the conditions stipulated by the Criminal Proceedings Act, (iv) a tax authority for the purpose of tax proceedings to which the client is a party, and (v) the Ministry of Finance when carrying out supervision.[14] A bank shall report on matters that are subject to confidentiality only to the persons entrusted with the supervision of banking operations. The exchange of information between the Czech central bank and supervisory banking bodies and similar institutions in other countries shall not be regarded as a violation of confidentiality if it concerns information on entities operating or intending to operate on the territory of the respective country. Article 48 of Poland's Bank Law also codifies the rule and its exceptions.

In Denmark, the duty is codified in the Code on Banks and Savings Banks of 1991 (originating in 1974). There are similar codifications in Finland (Deposit Banks Act, 1991) and Norway (1961, 1988) but not Sweden. Examples of common law countries that have codified the *Tournier* rules are Singapore[15] and the Bahamas.[16] In Mexico, bank secrecy was codified in the Credit Institutions Law of 1990.[17] A similar provision applies to trusts.

Pakistan is an example of a country that reinforced bank secrecy with a view to promoting confidence in the banking system and attracting foreign private investment and foreign exchange into the country. The Protection of Economic Reforms Act, 1992, provides that the secrecy of "bona fide banking transactions" shall be strictly observed by all banks and financial institutions. Moreover, there is a special provision that the banks must maintain complete secrecy in respect of transactions in foreign currency accounts.[18] No penalties are prescribed by the Act. The degree to which this legislation overrides the usual exceptions is a matter of debate.

In Portugal, the bank secrecy provisions in Decree Law No. 2/78 were introduced on January 9, 1978, following the notorious listing in a newspaper of details of individuals' bank account details after a coup d'état.[19] The law was primarily intended to reestablish confidence in the banking system. Consequently, Portugal is a country that has a high degree of bank secrecy that is subject to EC directives, such as the money-laundering directive.[20] Although disclosure for the purpose of providing criminal testimony can ultimately be ordered by a court, there appears to be no exception for compulsory disclosure to the tax author-

ities. Bank secrecy cannot be compulsorily overridden by mandatory testimony in civil proceedings.[21]

In Russia, the duty is codified in Article 26 of the Federal Law No. 17-FZ of February 3, 1996. A breach attracts damages. There are exceptions covering court orders, tax authorities, crime authorities, bank supervisory authorities, executors of estates, auditors, and the like.

In South Korea, the Real Name Financial Transaction Law in general provides for the protection of secrecy by financial institutions.[22] This law does not mention credit transactions, but, nevertheless, it is thought that these are covered in any event by a customary contractual duty.

In Switzerland, the duty was codified in 1934 mainly to assist flight capital from Nazi Germany. Article 47 of the Federal Law on Banks and Savings Banks criminalizes both negligent and intentional breaches of bank secrecy.[23] The section applies also to breaches committed abroad by Swiss bank employees. There is a corresponding provision protecting manufacturing or business secrets in Article 273 of the Swiss Penal Code.[24] In Switzerland, numbered accounts are used, but in all cases someone in the bank knows the true account holder. The object is to strengthen secrecy by reducing the number of bank employees who know the identity of the account holder.

Constitutional Provisions

A number of countries trace bank secrecy back to provisions in their constitutions, which, for example, protect the privacy of citizens[25] or guarantee the individual's right to an uninhibited development of his personality.[26] It appears unusual that bank secrecy is actually constitutionally entrenched, and the discussion of the constitutional basis appears to be often no more than an indication of a parallel desire to protect individual freedom by entrenching privacy against the country.

Where bank secrecy has indeed been elevated to an issue of constitutional significance, the effect may be that a higher parliamentary majority is required to change the law and that violations are justiciable before a constitutional court set up to protect the constitution. An example is Section 38 of the Austrian Banking Act of 1993.

However, there have been decisions in a number of jurisdictions where, for example, search and seizure powers by the tax authorities have been held not to be unconstitutional.[27]

Scope of the Bank Secrecy Duty

The propositions set out below about the scope of the bank secrecy duty appear to be universal in commercially developed countries.

Customers

The duty only applies to customers. However, the duty usually applies to information disclosed by a potential customer during prospective negotiations, although the customer does not in the event become a customer. This is true in England and Germany.

Third Parties

If a bank acquires information about a third party from a customer, the bank owes the secrecy duty to its customer, not the third party. This principle probably applies in countries following the *Tournier* rules,[28] as well as in Austria.

Information

The duty applies to specific details, for example, credit balances, loans, security, and transactions. Disclosure of information that does not enable the customer to be identified is exempt, for example, general disclosures in financial statements or prospectuses for securities issues. Mere disclosure of a business relationship may be a breach of the duty, for example, if the result is that the customer's deposits are attached. Disclosure that a bank does or does not have an account for a customer is a breach in Germany. Casual information acquired outside the banking relationship, for example, on the golf course or in social gatherings, should be treated cautiously.

Duration

The duty continues after the account is closed according to *Tournier*.[29] This rule appears to be universal.

Banks

The duty applies to all credit institutions that have deposit accounts with customers. Therefore, it will typically apply to other financial institutions, such as building societies and savings cooperatives. Codifications often so provide.

The duty usually applies to local branches of foreign banks because they are within the relevant jurisdiction. In Switzerland, Article 2 of the Federal Law on Banks and Savings Banks of 1934 so provides.[30] Conversely, foreign branches are subject to the secrecy rules of the countries in which they reside, not those of the country of the head office. The

national secrecy rule is not extraterritorial. Thus, Switzerland does not apply its secrecy laws to foreign branches of Swiss banks. The extent to which the country of the head office can enforce its disclosure policies in relation to branches and subsidiaries abroad is reviewed further in this chapter.

Banks are liable for the defaults of their officers and employees in the course of their duties on general principles of law. Furthermore, the duty usually applies to those who necessarily have access to bank information, for example, external lawyers, accountants, consultants, insolvency administrators, and the like. The Swiss Banking Act has been amended so as specifically to extend the duty to "mandatories."[31] Often these external agents are bound by their own secrecy codes, for example, the duty of confidentiality that a lawyer owes to a client.

National Branches and Affiliates

In England, information may not be disclosed to affiliates in the same group, for example, a parent or other subsidiaries.[32] This has implications for management control of the group; marketing leakages to nonbank affiliates (for example, insurance, investment, and travel businesses); and disclosure to credit card companies in the group.

There are compromise solutions. In Denmark and Finland, the sharing of information in a banking group is statutorily permitted, subject to controls. However, in Luxembourg a 1981 law permits credit establishments to communicate certain restricted information of a general nature to controlling shareholders.[33] In addition, in Singapore an exception to the secrecy obligation contained in Section 47 of the Banking Act provides that the branch of a foreign bank can provide information to its head office relating solely to credit facilities granted to a customer.[34] However, in Switzerland the veil of incorporation is not lifted.

Checks

There is much divergence with regard to checks. In the United States, it has been held that a check is not a confidential communication but rather a public negotiable instrument that has been knowingly set "afloat on a sea of strangers."[35] Evidently, there is no privacy as regards bank statements in connection with checking accounts, even where a client has attempted to immunize his business transactions from discovery by the device of a lawyer's commercial checking account.[36]

Other countries take a more restrictive view. For example, in Germany if a check is not honored, the holder can ask the relevant bank for infor-

mation on the drawer, such as the name and address of the drawer, which the bank is entitled to provide in order to enable the check claim to be processed. The bank may not give additional information about the drawer's financial situation. The bank can also inform the drawer about the payee and the circumstances of payment.

The position in France is at the opposite end of the scale from that in the United States. An example is the decision of the Court of First Instance of Paris in which a drawer of a check requested his bank to send him a copy of both sides of the check and the name of the payee bank.[37] The bank sent its customer only a photocopy of the first side of the check, that is, the part the customer had executed. It was held that the bank was entitled to refuse delivery of the reverse side of the check.

In Greece, if a check is not payable for lack of funds, the bank must report the matter to the public prosecutor for prosecution of the issuer.[38] This is also the position in the United Arab Emirates, and it may well be common elsewhere.

Funds Transfers

The transfer of funds from one account to another inevitably involves disclosure to the participating banks and to any transmitting agency. Check rules could be applied by analogy as appropriate. In the United States, the Financial Crimes Enforcement Network of the Department of the Treasury and the Board of Governors of the Federal Reserve System issued a regulation requiring financial institutions to collect and retain certain information pertaining to wire transfers of $3,000 or more.[39]

Conflicting Duties

The secrecy duty may be in conflict with the law of misrepresentation or fiduciary duties, as where the bank advises a customer on a transaction with another customer or is banker to both companies in a takeover. In such a situation, if the bank is in the position of a fiduciary, it may have a divided loyalty. In *Kabwand Pty. Ltd. v. National Australia Bank Ltd.*,[40] a bank advised a customer purchasing another customer's business but did not disclose that the target business was unprofitable and was heavily indebted to the bank. It was held that the secrecy duty overrode a statutory duty not to engage in misleading or deceptive conduct, under Section 52 of the Trade Practices Act (Commonwealth), 1974. However, in *Smith v. Commonwealth Bank of Australia*,[41] it was held that a bank that was banker to both seller and buyer of a business could not advise the buyer because the secrecy duty owed to the seller constituted a conflict of interest.

In similar circumstances, an English court would probably not find a conflict on the ground that customers dealing with large banks must expect that the counterparty may also be a customer and that the bank will owe a secrecy duty to the counterparty. In *Kelly v. Cooper*,[42] an estate agent acted for sellers of two contiguous properties sold to Ross Perot who wanted one big property. If the second seller had known that fact, he would have held out for a higher price. The court held that the estate agent had a duty of confidence to the first seller, and said duty prevented the agent from disclosing such information to the second seller. The court noted that the second seller should be expected to know that estate agents will often act for owners of comparable property, and it was therefore an implied term that the agent must honor a secrecy duty to those other owners.

In a Canadian case, the bank was held liable for a conflict of interest. In *Standard Investments Ltd. v. Canadian Imperial Bank of Commerce*,[43] a corporation revealed to a bank their plans to take over a trust company. The trust company was also a customer of the bank, and the bank had recently purchased for its own account a 10 percent stake in the trust company to help prevent a takeover attempt. Subsequently, the bank gave advice to the corporation. The court held that reliance by the corporation on the bank gave rise to a fiduciary relationship, which required the bank to disclose any conflict of interest. The bank was liable for damages for failure either to disclose the conflict or to have refused to advise.

In the United States, several cases have held that a bank is not precluded from financing a hostile takeover of one of its customers, although it is possible that the bank should not use confidential information about the target customer in order to decide whether or not to finance the takeover.[44]

A Chinese wall that would segregate confidential information within a bank may prevent conflicts; however, the efficacy of Chinese walls is outside the scope of this chapter.

Guarantees

Another case of potential difficulty arises when a bank is taking a guarantee. The question is whether the bank must disclose the country of the customer's account to the prospective guarantor. Normally, a bank can (and often must) remain silent because there is no duty to disclose, but this duty has been eroded in extreme cases. A risk is that the bank usually says something, in which event any omission may be misrepresentation; a half-truth is as good as a lie. A bank must not conceal from the guarantor facts that are required to render comprehensive answers to the

guarantor's questions.[45] A positive misrepresentation will always be actionable. The bank should obtain the customer's consent (which may be implied). The question has been much litigated in Australia.[46] In Finland, a guarantor is entitled to information about the credit. In New Zealand, the courts have decided that a bank must disclose to a guarantor facts about the debtor's being guaranteed that are unusual or are different from those that the guarantor might naturally expect. There is English case law to the same effect.

If a customer requests the guarantor to give a guarantee, and the guarantor pays the guarantee, the guarantor should be entitled to information about the customer to enable the guarantor to recover indemnity. This may be the case whenever a third party is a successor to a claim by operation of law—in this case, subrogation. This has been so held in Austria.[47]

Customer Remedies and Sanctions

The customer remedies may be civil, criminal, and/or administrative.

Civil Remedies

Civil remedies include, for example, damages for breach of contract or tort.[48] Punitive damages would be unusual in jurisdictions based on the English legal system, except perhaps in a very extreme case. The English courts do not favor criminalizing civil awards by treble damages and the like. Actual damage may be difficult to prove. Punitive damages are not available in Germany.

Injunctions are usually available for threatened breaches, for example, in common law countries and Germany. There are no criminal sanctions in Belgium, as Article 458 of the Criminal Code, which criminalizes breaches of the secrecy duty for doctors and the like, has been held not to apply to banks.[49] The duty is regarded not as one of secrecy but of "discretion." Nor are there criminal sanctions in the Czech Republic, Germany, Italy, Japan,[50] Poland, Spain, or Sweden. The same is probably true in the Netherlands.[51]

Criminal Remedies

In some countries, bank secrecy is criminalized. There may be various reasons for this: because secrecy is elevated as a fundamental legal and moral policy; because civil damages are often an inadequate remedy, in that loss is difficult to prove in many cases; because banks have been nationalized, and it is desired to underline the principle that this will not lead to disclosure to the state as owner; and sometimes perhaps because

secrecy is desired to defeat foreign extraterritorial demands for disclosure. Criminalization is unusual in common law countries, except for tax haven jurisdictions. Usually, the injured customer also has the civil remedies of damages and injunction, but further investigation would be required to establish the extent to which the criminal sanction excludes civil remedies.

In the following countries, breaches of the duty are criminal: Austria,[52] the Bahamas,[53] the Cayman Islands,[54] Finland,[55] France,[56] Greece,[57] Luxembourg,[58] Malta,[59] Mexico,[60] Singapore,[61] South Korea,[62] and Switzerland.[63] Note that many developed countries, while not criminalizing ordinary breaches, may criminalize breaches by government employees (for example, under banking or official secrets legislation, as in Belgium and Germany) in relation to the bank regulatory authorities. Countries differ according to whether only individual employees may be visited with criminal sanctions or whether the bank itself may be penalized.

Administrative Remedies

Theoretically, if a bank breaches the duty of secrecy habitually, bank regulatory authorities may intervene, by virtue of their general powers, to revoke its authorization on grounds of mismanagement.

Governing Law

Where the duty is contractual—as in most jurisdictions based on the English legal system—the extent of the duty is a matter for the governing law of the contract, in accordance with the usual principles of international law, subject to an overriding statute. The governing law of bank deposit accounts generally is not expressly chosen and is often the law of the jurisdiction where the bank branch owing the account is located. In Europe, reference should be made to the 1980 Rome Convention on the Law Applicable to Contractual Obligations.[64]

Disclosure Generally

There are so many exceptions to the duty of secrecy that in England the duty has been described as a duty to disclose.[65] However, there are great differences in approach for the reasons previously stated. The main exceptions in legally developed countries are addressed subsequently. A miscellany of general matters is first mentioned.

Blocking Statutes

Some countries have adopted blocking statutes whereby the authorities can order a domestic citizen or business not to produce information to for-

eign authorities. The most important of these were directed against U.S. extraterritorial jurisdiction, mainly in the antitrust field, and some are limited to maritime transport, following U.S. antitrust measures in the shipping trade in the 1960s. The following countries are among those having blocking statutes of varying scope: Australia (1976–81); Belgium (1969–79) (ships and aircraft); Canada (1947–80); Denmark (1967) (ships); Finland (1968) (ships); France (1968–81); Germany (1965–66) (ships); Italy (1980) (ships); the Netherlands (1956); New Zealand (1980); Norway (1967) (ships); the Philippines (1980); South Africa (1978); Sweden (1966) (ships); and the United Kingdom (1980).

International Conflicts

In view of the divergent international attitudes toward bank secrecy, there are bound to be international conflicts between courts. Typically, the head office or parent of a bank in one jurisdiction is legally obliged to disclose information held by its foreign branch or subsidiary, which is legally obliged not to disclose by the foreign law applying where the branch or subsidiary is located. Many of the cases have involved the extraterritorial jurisdiction of U.S. law and courts. The U.S. courts have sometimes permitted a "good faith" defense if the U.S. bank acted in good faith by endeavoring to comply with the U.S. order for disclosure by its foreign branch or subsidiary but is frustrated because disclosure would involve a violation of foreign law.[66]

Fishing Expeditions

A fishing expedition is an attempt, either by the authorities investigating an offense or irregularity or by private litigants, to obtain evidence to establish their case or to ferret out evidence by general enquiries for information pursuant to statutory or court discovery rules. Such an attempt could be a request for all documents that relate to a particular breach or might disclose a breach; or all accounts and correspondence of a specific customer or all customers of a particular class. Numerous countries tend to limit fishing expeditions using the following methods:

- by insisting that proceedings have started so that the disclosure is subject to judicial control and the dispute and the defendant are specifically identified. (However, the commencement of proceedings of some sort can be a tipoff to criminals. Hence a requirement that criminal proceedings have already been initiated is often construed liberally—as in Austria—to cover preliminary pretrial investigative proceedings by a court so that police enquires can be favored.);[67]

- by requiring a well-defined and corroborated suspicion in advance
- by requiring that the disclosed matters must be shown to be strictly relevant to the case;
- by requiring specific disclosure requests, that is, prohibiting general requests for all information and documents relating to a customer. (There must be specific evidence that the bank has the document, not just a suspicion.); and
- by excluding information showing other civil causes of action or other crimes accidentally obtained in the course of an investigation.

The position depends on the issue and the jurisdiction. The objection to fishing expeditions is noticeable in most developed countries. The U.S. Federal Rules of Civil Procedure permit discovery of anything that "appears reasonably calculated to lead to the discovery of admissible evidence."[68]

Insulation of Authorities

Disclosure rules in favor of the authorities often prescribe that the receiving authorities may not divulge the information to other departments of state; for example, bank supervisors may not disclose such information to the tax authorities. This insulation, or firewall, is no doubt a genuflection in the direction of bank secrecy enhancing public confidence in banks. However, there are many examples of derogations from this view. Free disclosure of potential serious crimes to the criminal authorities is a near universal exception.

Disclosure Limited by Functions

Generally, authorities who are permitted to pierce bank secrecy may only do so for the purposes of their functions, such as supervision. Debate may center upon whether the ambit of the specified functions is to be construed widely or narrowly.

Official Secrets

Authorities receiving information are generally subject to duties of secrecy on the lines of those applicable to public officials. Breaches are usually a criminal offense.

Disclosure with Customer Consent

A bank may disclose information if the customer consents. The benefit of the duty is a privilege of the customer who may waive it, for example,

in connection with public announcements of a completed syndication by a tombstone advertisement. The consent may be implied. Singapore is exceptional (but not alone) in requiring a written consent.[69]

However, in Luxembourg, where violation of bank secrecy is criminalized, the view is that a victim may generally not waive his protection under criminal law. It therefore follows that in Luxembourg, if the customer expressly authorizes the bank to give information to third parties, the bank is authorized to provide the information but it is not obliged to do so.[70] Professional secrecy is a duty of the bank, but also a right of the bank.

Some of the main areas of difficulty with consent are credit references, central credit reference agencies, loan sales, securitizations, and outsourcing of bank functions. Each of these is analyzed subsequently.

Credit References

Banks commonly give credit references about their customers at the request of other banks, for example, when a customer is applying for credit. This practice, if kept within bounds, is generally considered to be beneficial to customers. Usually, banks only give the information in general terms (for example, a general statement about creditworthiness does not detail information about the country of the account or transactions) and only give the information to approved enquirers (usually other banks). Many countries draw a distinction between credit references about commercial customers (which are given without specific consent, subject to limits) and credit references about individuals (which often require consent).

In England and the United States, a negligent credit reference is usually actionable, subject to any effective exclusion of liability.[71] There are numerous similar decisions in other jurisdictions. Banks in England commonly give references without express consent on each occasion, on the basis that consent is usually implied. Australia has a Code of Conduct issued under the Privacy Act, 1988, relating to consumers (not corporations).[72] In Canada, the Canadian Bankers' Association has a voluntary Model Privacy Code for Individual Customers of 1990,[73] influenced by the *Guidelines on the Protection of Privacy and Transborder Flows of Personal Data*[74] prepared by the Organization for Economic Cooperation and Development. Canadian banks often seek consent if a consumer is involved.

In Austria, there is a statutory exemption for generally phrased information on the financial situation of a business (not specific details) as usually given by banks, unless the client expressly objects to it.[75] Banks use

standard formulations. In Denmark, there are rules on the release of credit reports.[76] Consent is required for private customers. The rules require that the credit report be issued in general terms. Moreover, the bank must be satisfied that the applicant has a business interest in obtaining the information. In France, credit information is given apparently on the basis that the bank secrecy rule is not contravened if the information is general and nonspecific.

In Germany, the terms on which banks may give references are generally governed by the general terms of business, which are in standard form for all commercial banks.[77] The usual provision is that banks can give information about certain commercial customers without express consent on each occasion but not about personal customers. Generally, the request for information must be routed through a bank and is limited to basic information about the customer, for example, information available on the public business file together with a statement of creditworthiness.

In Japan, banks give credit references to other banks without specific consent. The New Zealand Code of Banking Practice (which is nonstatutory) insists that bankers' references must not be given without the customer's consent.[78] In Norway, the Act on Savings Banks of 1961 permits the board of directors of a bank—there is a high degree of formality—to give information on behalf of the bank to another bank without being subject to secrecy.[79] Other credit institutions governed by secrecy law and credit institutions abroad are probably included. This exception will allow the transfer of intragroup information and will also allow one bank to advise another about the creditworthiness of a customer.

In Pakistan, the exchange of credit information between banks on a confidential basis is specifically recognized in banking legislation.[80] In Singapore, an exception to the secrecy duty in Section 47 of the Banking Act permits the disclosure of information required to assess the creditworthiness of a customer with regard to a bona fide commercial transaction so long as the information is general.[81] In South Korea, confidential information can be disclosed to other financial institutions by virtue of the Real Name Financial Transaction Law in order to permit information exchanges about creditworthiness.[82]

Credit Reference Bureaus

Credit reference bureaus are established primarily to protect credit providers from habitual defaulters. They are private blacklists. For example, all banks in Germany also belong to a special scheme, called by its acronym SCHUFA. It is a nonpublic credit reference agency for private customers. Disclosure of information requires the customer's appropriate

consent. Hungary set up its Interbank Debtor and Borrower Information System in 1996. It is available only to banks. In the Netherlands, most banks and various other institutions are members of the BKR, which is a credit bureau for private individuals. Members supply information on credits granted to private persons, and a record of defaults is maintained. Members must supply the BKR with information and must also consult the BKR database before granting credit to a private person. The banks consider that there is no breach of confidentiality because only banks or other financial institutions can become members, and all members are obliged to keep BKR information secret. Data protection legislation in various countries gives individuals the right to inspect credit reference entries and insist on corrections.

Other Cases

Some other cases of disclosure with implied customer consent are the following:

- Loan Sales. Permission for assignments and participations in the original credit agreement should be an implied consent to loan sales and participations.
- Securitization of Loans. The sale of a loan to a specially formed vehicle involves disclosure to the buying vehicle and, potentially, to investors. Bank secrecy can be a serious hindrance to these schemes.
- Outsourcing. Where a bank arranges for some of its functions (for example, computer systems, credit card administration, data processing, and the like) to be performed by external parties, it may not always be a simple matter to find a disclosure gateway.
- Miscellaneous. There may be other special situations where consent is implied. In *Lee Gleeson Pty. Ltd. v. Sterling Estates Pty. Ltd.*,[83] a customer authorized his bank to confirm to a builder that the customer had sufficient money to pay the builder if the builder expedited the work. The customer subsequently countermanded payment instructions to pay the builder, but the bank did not tell the builder. It was held that the customer had implied consent to the disclosure of the countermand. The bank was liable to the builder.

Disclosure to Protect the Bank

The bank may disclose to the extent necessary to protect its interests (and usually only to that extent). This proposition appears universal. Instances when disclosure is necessary include when the bank is suing the

customer for a default;[84] when the bank is moving a claim in the liquidation of a customer; when the customer sues the bank; and when the bank is the "piggy in the middle," for example, in letter-of-credit disputes between the customer and the beneficiary. In this latter case, the bank may wish to protect its rights of setoff or pledge.

In Austria, a credit card issuer has been held to be permitted to disclose the address of the card owner to a business from which the owner had purchased goods but who instructed the bank not to pay the invoice.[85] In New York, it has been held that a borrower from a bank could not complain if the bank divulged that the borrower had defaulted on the loan.[86]

Disclosure of Crimes

Serious Crime and Money Laundering in General

Most countries permit banks to disclose common crimes to the authorities. In *Tournier*, it was recognized that a bank may disclose information if this is in the public interest.[87] In *Canadian Imperial Bank of Commerce v. Sayani*,[88] a borrower provided financial statements to a trust company in negotiations for a loan. These financial statements allegedly failed to disclose that the borrower had defaulted on a loan to a bank. The trust company sought a credit reference from the bank which disclosed the default. The borrower sued the bank for damages for breach of confidentiality. It was held that the bank had a public duty to disclose the alleged misrepresentation, even if it did not necessarily constitute a fraud or crime. A similar example is the case *R v. Curtis*[89] from New Zealand.

Crimes Covered

Countries differ as to whether statutory disclosure applies to all crimes, all serious crimes, or only certain specified crimes. Legislation covering specified serious crimes will normally apply to fraud (including securities frauds), theft, kidnapping, extortion, blackmail, bribery, official corruption, drug trafficking, terrorism, and insider dealing; but the intensity of legal disapproval differs greatly as compared to the classical crimes.

A special area of concern has been gigantic scams—advance-fee frauds, letter-of-credit frauds, and "prime-bank-guarantee" frauds—which are often very primitive but nevertheless a threat to banks and to unsophisticated persons who are fraudulently deceived.

Other Differences

Reasonable protections for those accused of crimes and the need for due process have always been a central concern in civilized societies and

a major preoccupation of constitutional law throughout history. However, countries differ on how to reflect these values. Areas of divergence in this context are:

- whether criminal proceedings must actually have begun before police authorities can override bank secrecy. (This impedes preliminary investigations and allows tip-offs, but stems from the concept of "innocent until proven guilty.");
- whether the lifting of secrecy requires a court order or can be initiated directly by the authorities without judicial supervision to protect the citizen;
- the degree of control of fishing expeditions, for example, requirements for reasonable prior evidence of a crime and for disclosure of specific documents. (These controls are designed to prevent oppressive investigation.);
- whether the bank can or must notify the customer in order to protect the customer against unwarranted intrusion. (The disadvantage is that this leads to forewarning a criminal customer.);
- whether the procedural safeguards or the protection of secrecy itself is more extensive in the case of fiscal and economic crimes, for example, tax evasion;
- whether banks have a duty to report, as opposed to a mere right to whistle blow; and
- whether the regime overrides the privilege against self-incrimination.

Domestic Money Laundering

Money laundering is the attempt by criminals to conceal the origins of the proceeds of their crimes—usually cash—by converting traceable "dirty" money into "clean" money, such as bank deposits; gold; and investments in securities, property, or companies. Knowingly participating in money laundering is also considered money laundering. The money laundering process involves the following three steps:

- placement: direct deposit in banks or the purchase of investments, art, gold, or foreign currency;
- layering: multiple transactions to confuse the audit trail, for example, multiple transfers, purchase and surrender of insurance policies, use of dummy companies, and purchases of bearer bonds; and
- integration: the laundered money becomes part of the legitimate economy, for example, as loans or equity investments.

The transactions can be extremely complicated. The main international documents relating to money laundering are:

- the Statement on the Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering, 1988.[90] (The statement was prepared by the Basle Committee on Banking Supervision. It consists of nonlegal ethical principles and is intended to encourage the banking system not to permit money laundering. It was subsequently endorsed by the Offshore Group of Banking Supervisors (19 members including the Cayman Islands, Cyprus, Hong Kong, Jersey, and Singapore) and has resulted in a number of national codes of banking practice.);

- the UN Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, 1988.[91] (The Vienna Convention, as it is commonly referred to, has been ratified by over 100 countries. It sets out minimum standards; requires countries to criminalize drug trafficking and the international laundering of the proceeds;[92] and provides for mutual legal assistance.[93] This convention specifically overrides bank secrecy.[94] It is the most far-reaching multilateral treaty on criminal assistance.);

- the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime, 1990.[95] (In force since 1993, it contemplates that countries can extend the criminalization of money laundering to nondrug offenses, such as serious crime, arms dealing, and terrorism.);

- the *Scheme Relating to Mutual Assistance in Criminal Matters Within the Commonwealth,* 1986,[96] which was amended in 1990 and subsequently supported by a political intent declaration of 47 out of 50 Commonwealth countries in Cyprus in 1993;

- the EC Directive on Prevention of the Use of the Financial System for the Purpose of Money Laundering, 1991.[97] (This applies to Vienna Convention crimes and to any other crimes designated by member states. Jersey, Guernsey, and the Isle of Man have enacted legislation based on this Directive.);

- the Organization of American States Model Regulations Concerning Laundering Offenses Connected to Illicit Drug Trafficking and Related Offenses, 1992.[98] (This is limited to drug trafficking and related offenses.); and

- the Forty Recommendations of the Financial Action Task Force.[99] (Established in 1989, the Financial Action Task Force has 26 members, including European and Scandinavian countries, plus Australia,

Canada, Hong Kong, Japan, New Zealand, Singapore, Turkey, and the United States. There is also a Caribbean Financial Action Task Force centered in Trinidad.)

The main techniques used to control money laundering are transaction size reports and suspicion reports. Transaction size reports are filed by banks to report transactions above a certain size, including connected transactions that individually do not exceed such statutory limit. This blanket system is said to result in an avalanche of filings and to be costly. However, it has a deterrent effect, and suspicions from other sources can be substantiated by the reports. Although bureaucratic and paper intensive, the system is easier for banks. The best known example is the United States, which has a $10,000 threshold.[100] Another example is Australia.[101]

Suspicion reports are filed by banks to report suspicious transactions. It is the approach used in a majority of countries, including the United Kingdom. Forewarning the customer is prohibited. Banks have a defense if they report. Disadvantages of this approach are said to be (i) the system requires sophisticated staff, (ii) bank employees must become amateur detectives/informers, and (iii) the reporting of a suspicion can create a serious slur if unjustified. France has a system for compensating those who are wrongly suspected. Sometimes only transactions above a certain threshold must be reported.

Common to most systems are (i) the need for customer identification (the "know your customer" standard obviates anonymous bank accounts), (ii) recordkeeping and retention requirements, (iii) staff training, and (iv) a prohibition on tipping off the suspect. There is also usually provision for search and seizure.

Country Survey

This part surveys various countries showing the extent to which bank secrecy is eroded by the criminal law, not merely money laundering.

The Bahamas has a fairly typical code of conduct inspired by the Basle principles. The *Code of Conduct for Members of the Association of International Banks and Trust Companies in the Bahamas* covers cooperation with the central bank, "know your customer" standard, rejection of criminal customers, avoidance of violations of foreign fiscal and exchange control laws, and maintenance of confidentiality.[102]

Britain has a suspicion-reporting system for money laundering. The rules are extremely complex. Guidance Notes have been issued by the Joint Money-Laundering Steering Group.[103] The British money-laundering rules apply to all serious crimes, not just drug-related crimes. Some of the

main legislation applying to criminal investigations are the Drug Trafficking Act, 1994; the Prevention of Terrorism (Temporary Provisions) Act, 1989; the Criminal Justice Act, 1993; the Money-Laundering Regulations, 1993; and the Criminal Justice (International Cooperation) Act, 1990.[104] Section 9 of the Police and Criminal Evidence Act, 1984, allows the court to order a bank (and others) to disclose to the police certain information material for the purposes of a criminal investigation. The suspect does not have to be informed, because he or she would be forewarned. The Criminal Justice Act, 1987, confers wide powers of investigation on the Serious Fraud Office; the regime is inquisitorial and does not protect against self-incrimination, so that the right to silence is overridden.[105]

In *Tournier*, it was recognized that there was an exception to secrecy in the case of the public interest. This exception is generally understood to refer mainly to the reporting of serious crimes.

In addition, the English courts restrict disclosure under the Bankers' Books Evidence Act, 1879 (which is addressed further in this chapter) and do not allow it to be used for fishing expeditions in the hope of finding evidence to hang a case; there must be other evidence of a crime. The guidelines for criminal actions were laid down in *Williams v. Summerfield*.[106] There must be firm proof that the account is material evidence. The courts will order disclosure in the case of a crime of fraud provided that evidence is shown that the customer is *prima facie* guilty of fraud.[107]

In Canada, money-laundering legislation was introduced by amendments to various acts, including the Canadian Criminal Code, to criminalize money laundering in relation to a wide variety of offenses, including drug offenses. The other main offenses cover bribery, fraud, secret commissions, and illegal gambling. In disclosing facts that gave rise to a suspicion of money laundering, the financial institution may rely on an amendment to the Criminal Code, which provides that disclosure to the authorities of a reasonable suspicion of the crimes concerned is justified. In addition, the Proceeds of Crime (Money Laundering) Act of 1991 requires institutions to keep records of transactions above a limit of Can$10,000. Although the Act does not contain reporting obligations, these records are available for reporting transactions under the money-laundering statutes. The Canadian authorities have also issued a policy of *Best Practices for Deterring and Detecting Money Laundering*.[108]

In France, bank secrecy under Article 57 of the Banking Law of 1984 is overridden in the case of crimes for which criminal proceedings have begun, including preliminary investigations.[109] In certain cases, the bank may not notify the client of the pending investigation or testimony.

In Germany, bank employees are bound to appear as witnesses in criminal proceedings and to testify. An employee can refuse to testify if this involves self-incrimination. In urgent situations, the prosecutor can confiscate evidentiary business documents without prior written court approval, but the search and confiscation must be restricted to evidence essential for the investigation.[110] There are other provisions to prevent fishing expeditions.

In regard to Greece, the Bank of Crete litigation in 1988 illustrates international cooperation in the case of criminal fraud.[111] In this case, it was alleged that misappropriation had been carried out by the chief executive of the Bank of Crete on a very large scale. By reason of the secrecy laws in Greece, which prevented disclosure to the criminal authorities during investigation (but not during the actual criminal proceedings that were subsequently brought), it initially proved impossible to substantiate the fraud. However, the Bank of Greece received from a New York bank information that revealed that the chief executive of the Bank of Crete had allegedly falsified deposit certificates concerning deposits of the Bank of Crete with the New York bank. This led to an uncovering of the alleged fraud.

Following that case, the 1971 Greek bank secrecy law was amended so as to allow disclosure in criminal proceedings and preliminary investigations by court order, provided the information is absolutely necessary for tracing and punishing a crime punishable with imprisonment of at least five years (that is, the lifting of secrecy applies only to major crimes and not to minor crimes where the secrecy duty continues). The lifting of secrecy applies in initial investigations without the necessity for a criminal prosecution to have been commenced. The law also lifts secrecy in relation to major crimes committed outside Greece, provided the Greek criminal courts have jurisdiction.[112] In addition, Law 1916 of December 28, 1990 pierces bank secrecy in relation to certain organized crimes—drug trafficking, murder, serious injury, hostage taking, hijacking, arson, and attacks against military or police installations.[113]

In Hong Kong, the Commissioner of Banking has issued a statement of principles on the prevention of the criminal use of the banking system including money laundering. In Ireland, there are provisions for the lifting of secrecy. In addition, the Offences Against the State (Amendment) Act, 1985, provides for the suppression of unlawful organizations involved with treason and violence against the state and for the transfer of their funds to the High Court. It has been held that this legislation is not contrary to the property rights guaranteed by the Irish Constitution.[114]

Italy has a tough anti-Mafia law, which partly implements EC directives on money laundering and partly extends previous legislation in the

Criminal Code.[115] Under this law, transfers of cash and bearer instruments are void if the total amount involved exceeds Lire 20 million, unless they are made through authorized intermediaries, such as banks, with the result that it is not possible in Italy to conclude any transaction in cash or payment by a freely transferable check in excess of the threshold. The authorized intermediaries must identify the person who executes a registrable transaction, keep records of registrable transactions, and communicate to the police any such transaction if the intermediary has reason to believe that it is connected with certain specified crimes—robbery, larceny for extortion, kidnapping, or drug-related crimes.

In Japan, money-laundering laws were enacted in 1991. These require banks to report their suspicions. Furthermore, in 1992 the authorities issued a memorandum requiring banks to identify their customers and to keep records of transactions. Luxembourg is exceptional in limiting the crime exception (subject to the EC Directive on Money Laundering). If a banker is called upon to testify before a Luxembourg criminal court, he is obliged to appear but may elect to either answer questions or refuse to answer them.[116] In the Netherlands, the judicial criminal authorities have large powers to compel third parties, including banks, to hand over documents and other materials in connection with an investigation. Generally, a court order is required, and there must be a reasonable suspicion that a criminal offense has been committed. There are special rules for tax fraud.

In New Zealand, the Serious Fraud Office Act, 1990, gives the Fraud Office wide powers to require the production of documents and to compel the answering of questions. The Fraud Office can disclose the information to any person who the director is satisfied has a proper interest in receiving the information. The New Zealand Proceeds of Crime Act, 1991, deals with money laundering. Pakistan has also issued guidelines on money laundering. The regulations require banks to take precautions against money laundering, but they do not specifically require disclosure of suspected activities to the authorities. However, the Dangerous Drugs Act, 1930, as amended, permits the tracing of assets of convicted drug offenders.

In Singapore, the self-regulating Association of Banks in Singapore has issued a set of guidelines on money laundering, which follow the Basle Committee concepts.[117] These guidelines are voluntary. Wide statutory powers allow the criminal authorities to obtain information about bank accounts. In South Korea, bank secrecy is overridden if necessary for evidentiary purposes in criminal proceedings.[118]

In Switzerland, bankers might be required to testify in the criminal courts under the Federal Code of Criminal Procedure and cantonal criminal procedure statutes, but bank secrecy is protected while the police are

still investigating; the override only applies to criminal proceedings. There are protective measures, for example, the sealing of documents so that a judge may assess whether disclosure is necessary. Usually, bankers do not have to testify in administrative proceedings. As to money laundering, the Swiss banks have entered into an Agreement on the Swiss Banks' Code of Conduct with Regard to the Exercise of Due Diligence, which imposes obligations whereby the banks must establish the identity of their clients, refuse funds of criminal origin, and refuse assistance in capital flight and tax fraud.[119] The bank controlling authority can impose fines for noncompliance. Article 305 of the Swiss Penal Code penalizes money laundering.

In the United States, in relation to governmental enquiries the common law rule of privacy of financial records no longer exists. This results primarily from a succession of laws designed to reduce crime and improve the investigation of regulatory and tax violations. Generally, information may be exchanged between government agencies in connection with law enforcement. The main legislation is as follows: the Bank Secrecy Act of 1970, which includes the Currency and Foreign Transactions Reporting Act;[120] the Right to Financial Privacy Act of 1978;[121] and the Money Laundering Control Act of 1986.[122] The legislation is heavily amended and accompanied by ancillary regulations and other legislation.

The Right to Financial Privacy Act of 1978[123] applies only to individuals and certain small partnerships, and not to corporations. It does not set out a substantial right of financial privacy on the lines of bank secrecy legislation in other jurisdictions. Instead, it merely sets out a number of procedural safeguards for the individual, for example, the necessity for some official or judicial order, compliance certificates by requesting agencies, and information on how a customer may judicially challenge disclosure—in each case subject to exceptions—for example, to prevent tipping off. There are a large number of other exceptions. This legislation is echoed by similar legislation in a number of states, for example, California and Illinois.

The basic object of the Bank Secrecy Act[124] is to require financial institutions to report certain domestic and foreign financial transactions to the authorities. These include deposits, withdrawals and transfers, and transports of currency or monetary instruments in an aggregate amount exceeding $10,000. Persons who receive an excess of $10,000 in the aggregate in U.S. currency or other monetary instruments from outside the United States must also report. Persons subject to the jurisdiction of the United States, including U.S. citizens abroad, must disclose their interests in foreign bank accounts and the like exceeding $10,000. There are various exceptions, for example, for cash businesses, such as restau-

rants and retail businesses. Provisions deal with "structuring" (popularly known as "smurfing") whereby the threshold of $10,000 is avoided by dividing up transactions.

The Money Laundering Control Act of 1986 provides that money laundering is a criminal offense and penalizes both those who launder and those who facilitate the laundering.[125] The Act covers more than 30 criminal offenses ranging from espionage and trading with the enemy to narcotics trafficking. Criminal intent or knowledge must be proved, and, in this respect, the Act appears more respectful of traditional criminal law than the corresponding EC Directive.[126]

Disclosure by banks of suspicious transactions under the Money Laundering Act is voluntary rather than mandatory.[127] However, disclosure is encouraged because complicity is a serious criminal offense. Good faith disclosure of suspicions to the authorities can be made without any subpoena or court order, and, in such a case, the disclosing institution is protected from liability. The risk of liability for failure to report is heightened by virtue of a decision that a bank's knowledge is a summing up of the knowledge of all the bank's employees.[128] There are both civil and criminal remedies under the legislation, including regulatory powers to impose sanctions. Violations are relevant to the official approval of bank acquisitions.

International Cooperation on Money Laundering and Crime

Prescriptive Jurisdiction

As previously mentioned, the basic international position is that one country cannot legislate for another and cannot arrest or interrogate suspects on the territory of another country without the consent of that country. However, this is a very basic rule and is subject to numerous exceptions in national practice. International rules concerning the ability of a country to control criminal conduct—its prescriptive jurisdiction—make distinctions between the bases of such jurisdiction. While other classifications may be recognized, the author would conceptualize them as follows:

- Countries can punish crimes committed within their territory and injuring a person within their territory—the *objective territorial principle.*
- Countries can punish crimes committed within their territory and injuring a person outside their territory—the *subjective territorial principle.* The textbook example is firing a gun across a border.

Another example is sending a fraudulent prospectus or obscene material abroad. Countries do not allow their territory to be used to peddle poison to foreigners. The territorial link is that an essential element of the crime is committed locally.

- Countries can punish crimes committed abroad that have an adverse effect locally—the ***protection principle or effects doctrine.*** An example is insider dealing abroad in securities on a national market. This is more controversial, particularly in the field of economic crimes, such as antitrust, and is rejected by many countries in relation to exchange controls.
- Countries can punish crimes committed by their nationals, wherever they may be—the ***nationality principle.*** For example, U.K. legislation punishes, among other things, treason, murder, bigamy, and breaches of the Official Secret Acts by nationals wherever committed.
- Countries can punish crimes wherever committed if the crime is so serious or so dangerous to international order as to require international action—the ***universality principle.*** Examples are common crimes, such as murder, and grossly repugnant crimes, such as terrorism, war crimes, and hijacking. Crimes that essentially require international cooperation, such as narcotics trafficking, may have joined this list.

Multilateral Conventions

The main multilateral conventions on mutual assistance in criminal matters include the European Convention on Extradition, 1957;[129] the European Convention on Mutual Assistance in Criminal Matters of 1959;[130] the Inter-American Convention on Mutual Assistance in Criminal Matters of 1992;[131] the UN Convention[132] and EC Directive[133] on money laundering, mentioned previously; and a number of earlier multilateral treaties dealing with specific crimes, such as counterfeiting.

Bilateral Treaties

There are many bilateral treaties on mutual assistance in criminal matters. The following are a few examples.

The Bahamas has treaties with Canada, the United Kingdom, and the United States under its Mutual Legal Assistance (Criminal Matters) Act, 1988, which excludes foreign taxes and exchange controls. The Cayman Islands has similar treaties with Canada, the United Kingdom, and the United States. The mutual legal assistance treaties of the late 1980s between the Bahamas, the Cayman Islands, and the United States are of

particular interest because the Bahamas and the Cayman Islands have criminalized breaches of bank secrecy. These treaties override bank secrecy but are subject to a court order. In both cases, two weaknesses of British imperial extradition treaties—that criminal proceedings actually be pending and that the application is *inter partes*, resulting in the criminal being forewarned—are removed. However, a court order is still required.

For Canada, there is a Canada-U.S. Treaty on Mutual Legal Assistance in Criminal Matters of 1985, which provides for cooperation in most major criminal and regulatory offenses. It provides for exchanges of information, taking of evidence, the production of documents, search and seizure procedures, and the temporary transfer of detained persons. However, the evidentiary and procedural rules of the requested authorities and constitutional protections apply to these proceedings. This treaty is not applicable to private litigants. Canada has similar treaties with, for example, Australia, the Bahamas, France, Mexico, and the Netherlands.

The UN has developed a number of model treaties, for example, the Model Treaty on Mutual Assistance in Criminal Matters.[134]

Unilateral Cooperation Without a Treaty

Most legally developed countries have extradition laws and statutes dealing with international criminal cooperation and legal assistance to foreign authorities. Many of the older statutes stemmed from the desire to catch fleeing thieves and murderers and are ill-adapted to transnational fraud.

Typical restrictions are (i) the conduct must be a crime in the home country, usually a serious crime (the principle of double criminality); (ii) reciprocity; (iii) an exclusion if local proceedings are pending against the accused (to avoid double jeopardy); (iv) an exclusion of economic crimes, for example, tax, antitrust, and exchange control laws; (v) an overriding exclusion if the assistance impairs essential national interests or violates public policy; and (vi) a human rights exception, for example, racial, political, or abusive proceedings, or the absence of minimum protections for the accused. Some of these exclusions are found in Austria (although cooperation is possible on fiscal offenses) and also in Switzerland. Sometimes these laws and statutes require that proceedings must have been commenced and that the proceedings are *inter partes*—so that the fraudster is forewarned. These are typical restrictions in the older British imperial extradition legislation.

A few illustrations may be given. Both the Bahamas and the Cayman Islands have criminalized breaches of bank secrecy. However, these statutes are not permitted to be used as a blanket to facilitate crime or

fraud. In *United States v. LeMire*, the Cayman Islands Court of Appeal ordered disclosure of account information at the request of foreign authorities.[135] The charges had been filed, and the offense would have been a crime in the Cayman Islands. It was held that the Cayman Islands' confidentiality law should not be used to shield criminals. A similar conclusion was reached in the Bahamas case of *Royal Bank of Canada v. Apollo Development Ltd.*, provided that the request is not a fishing expedition.[136] However, a U.S. subpoena in a tax case was rejected by the Bahamian court in *Re Bank of America*.[137] The court enjoined the local branch of the U.S. bank from complying with the U.S. order to produce customer information.

One of the most celebrated cases was the U.S. case involving the Bank of Nova Scotia (BNS) in the 1980s. A customer of the Bahamian branch of BNS was being tried in the United States for tax and narcotics violations. The U.S. court issued a subpoena to BNS requiring it to produce documents relating to its customer. The bank refused to do so on the ground that this would be a violation of Bahamian secrecy laws. It was held that the bank should be obliged to comply and was guilty of contempt. Fines were imposed at the rate of $25,000 a day, finally totaling $1,825,000. On appeal, the action of the lower court was confirmed.[138] In *SEC v. Banca Della Svizzeria Italiana*, the U.S. Securities and Exchange Commission (SEC) attempted to obtain information from the bank about its customers in connection with an insider trading investigation.[139] The bank refused on grounds of Swiss secrecy and the U.S. court froze their New York bank account. Subsequently, the bank obtained the consent of their customers.

In Britain, a court can order disclosure in order to assist an investigation by a law enforcement agency of another convention country.[140] This is not confined to treaty countries. Previously extradition legislation allowed disclosure. In *Bonalumi v. Home Dept.*, Bonalumi was accused of criminal fraud in a Swedish court.[141] The U.K. government minister obtained a court order under Section 7 of the Bankers' Books Evidence Act, 1979, for inspection of the customer's bank account in England. The Extradition Act, 1873, applied. It was held that no appeal lay from the original court's order for disclosure.

Canada will cooperate unilaterally in an appropriate case even if there is no treaty. In the Canadian criminal case *Spencer v. The Queen*, the Canadian Supreme Court required disclosure by a Royal Bank of Canada employee living in Canada of the affairs of the bank's customer in the Bahamas even though that disclosure was a breach of Bahamian law and even though giving the evidence in Canada was a crime in the Bahamas.[142]

In Luxembourg, in the absence of a treaty an investigating judge may only carry out a letter rogatory from a foreign prosecutor if the judge has been previously authorized to do so by the Ministry of Justice and in cases where the offender may also be extradited, so that this excludes any cooperation in matters relating to taxes, customs, exchange control, and restrictions on trade (except narcotics). Generally, the authorities are cautious in allowing judicial cooperation except in the case of very serious criminal offenses and will not do so where a letter rogatory hides an alleged tax offense behind an apparent criminal offense. This view was emphasized in the Ambrosiano litigation.[143] Luxembourg is a party to the European Convention on Judicial Co-operation in Criminal Matters of 1959[144] and to the Benelux treaty on Judicial Co-operation in Criminal Matters of 1962.[145]

In Switzerland, mutual assistance is primarily determined by the Swiss Legal Assistance Act of 1981, with an accompanying ordinance of 1982. The grant of assistance is discretionary in the absence of a treaty. The Act contains restrictions along the lines of that above, except that reciprocity is not an absolute requirement. If cantonal law gives a right of refusal, then the persons entitled to the right cannot be obliged to furnish evidence to a foreign authority. Political, fiscal, and military offenses are excluded, except in the case of serious fiscal fraud, which is more than just a lie but a series of lies and falsification. Switzerland is a party to the European Convention on Mutual Assistance in Criminal Matters, 1959.[146] There is also the United States-Switzerland Treaty for Mutual Assistance in Criminal Matters, 1977, which contains similar principles to the 1959 European Convention, although it is more detailed.[147] There are more relaxed provisions in the Treaty for organized crime, which override bank secrecy even in the case of tax evasion.

The United States has a large number of exchange of information or mutual assistance treaties, including ones with the Bahamas, Barbados, Bermuda, the British Virgin Islands, the Cayman Islands, Costa Rica, Cyprus, Dominica, Dominican Republic, Grenada, Marshall Islands, Mexico, Peru, St. Lucia, St. Vincent and the Grenadines, and the Turks and Caicos.[148]

Insider Dealing

National Statutes

Insider dealing occurs when a privileged insider of a company, such as an officer or professional adviser, who has sensitive information gained by virtue of his relationship with the company and who exploits that infor-

mation to make a profit or avoid a loss by dealing in the securities of such company, the price of which would have been materially altered if the information had been disclosed publicly. The classic cases are where an insider has advance information about financial statements, a takeover, or some upturn or downturn in a company's fortunes. An EC Directive of 1989 on Insider Dealing requires member states to criminalize insider dealing and tipping in relation to certain securities markets.[149]

Apart from EU member states, other countries with insider dealing legislation include Australia, Canada, Indonesia, Mexico, New Zealand, Philippines, Singapore, Switzerland, South Africa, Thailand, and the United States. In Hong Kong, insider dealing is covered by the Securities Ordinance.[150] A tribunal established under the Ordinance has wide powers to inspect books and documents; its authority overrides bank secrecy.

English legislation permits inspectors who carry out investigations in relation to financial services to call for information from banks concerning suspected contraventions by a customer.[151]

International Cooperation on Insider Dealing

As to Europe, the EC Directive on Insider Dealing requires member states to outlaw insider dealing in relation to certain securities and provides for the cross-border sharing of information.[152] Article 8(2) provides that the competent authorities must be given all supervisory and investigatory powers that are necessary for the exercise of their enforcement functions. Employees of competent authorities are bound by professional secrecy "except by virtue of provisions laid down by law."[153] Pursuant to Article 10, the competent authorities must cooperate for the purposes of carrying out their duties and shall exchange information required for that purpose. Recipients must observe the professional secrecy applicable to the receiving authority.[154] They must only use the information for the exercise of their functions and in the context of administrative or judicial proceedings specifically relating to the exercise of those functions, subject to (i) obligations in judicial proceedings under the criminal law and (ii) use for other purposes or forwarding to other countries' competent authorities with the consent of the communicating authority.[155] Competent authorities may refuse to exchange information if, among other things, communication might affect the sovereignty, security, or public policy of the country addressed.[156]

In the U.S. insider dealing case of *SEC v. Levine*,[157] the SEC was able to obtain information from Bahamian banks pursuant to a request through the Bahamian Attorney General. In Switzerland, insider trading was criminalized in 1988 by a change in the Penal Code of 1937.[158] Bank

secrecy can be lifted for domestic cases and, in the case of judicial assistance in foreign proceedings, where insider trading is a crime abroad. By virtue of a special Memorandum of Understanding, 1987, with the United States, Switzerland agreed to grant assistance in "civil proceedings" concerning insider trading conducted by the SEC—as a relaxation of the usual requirement for mutual assistance that the proceedings be criminal. In *Re Santa Fe*,[159] the SEC was able to obtain information from Swiss banks under the 1977 United States-Switzerland Treaty for Mutual Assistance in Criminal Matters.

Disclosure to Banking Supervisors

National Supervision

Banking authorization and supervision is primarily intended to (i) protect depositors against fraud and insolvency, and (ii) protect the financial system against cascading or domino collapses—systemic risk. Apart from authorization, the main topics of financial supervision are capital adequacy; large exposures to single or related institutions, for example, a limit of 10 percent; liquidity; systems and controls; foreign exchange risk; and ownership and management. Regulators are commonly either central banks, for example, the Bank of England and the Bundesbank, or specialist supervisors, for example, the country and federal regulators in the United States (other than the Board of Governors of the Federal Reserve System).

Invariably, secrecy is lifted toward the regulatory authority. Obviously, regulators cannot regulate without information. Thus, the obligation to disclose large transactions showing large exposures involves disclosing a customer's confidential information. A risk for regulators is leakage of information or wrongful use of information. Domestic statutes and international treaties commonly require regulators to use information only for regulatory purposes and to maintain secrecy, subject only to the statutory gateways. Breaches are often criminalized.

In Britain, the Bank of England can require authorized institutions to provide such information and documents as it may reasonably require for the performance of its functions under the Bank Act, 1987.[160] These powers may be exercised in relation to corporations, directors, controllers, and managers. The Bank of England may not disclose the information unless it is in the public domain or in summary form, so that information relating to any particular person cannot be ascertained from it.[161] However, the Bank of England may disclose for the purpose of enabling or assisting it to discharge its functions[162] or to provide infor-

mation to a number of other supervisors,[163] as well as in various other circumstances.[164]

The English courts have authorized disclosure outside the statutory permission. In *Price Waterhouse v. BCCI Holdings (Luxembourg) SA*,[165] the U.K. government set up an inquiry into the affairs of a failed bank, BCCI. Price Waterhouse wished to make voluntary disclosures to the inquiry. There was no statutory provision allowing them to do so, but their involvement in the attempted rescue of BCCI had allowed them to acquire confidential information. The court held that the public interest required effective supervision of authorized banking institutions and the protection of deposits. These factors prevailed over the interests of confidentiality. Price Waterhouse was permitted to give information to the inquiry, subject to various restrictions to limit unnecessary breaches of secrecy.

The Bank of England's powers to call for information override the privilege of self-incrimination—the "right to silence." In *Bank of England v. Riley*,[166] a lady was prosecuted for theft. She had allegedly operated organizations that illegally obtained money from the public. The Bank of England, pursuant to its supervisory powers, obtained a court order requiring that she answer interrogatories as to the whereabouts of her assets. The supervisory powers allow the Bank of England to require a person to produce such information as it might reasonably need for the investigation of a suspected contravention of the Bank Act, 1987. The lady objected by relying on the privilege against self-incrimination. The court held that Section 42(1) of the Bank Act creates a duty for those suspected of contravening the Act to provide the requested information. This duty trumps the privilege against self-incrimination.

In addition, the power of the Bank of England to require information to carry out its supervisory duties overrides an injunction enjoining bank secrecy. In *A v. B Bank*,[167] the U.S. Federal Reserve Board was investigating a bank that traded in England. A New York court ordered the bank to produce customer documents. This order was blocked by an injunction of the English courts obtained by the customers. Based on information from the Federal Reserve, the Bank of England demanded documents from the bank relating to the customers, pursuant to its powers in the Bank Act. The court held that the Bank of England's request was pursuant to powers that overrode the injunction. The bank was ordered to produce the requested documents. The court stressed the importance of the Bank of England having unfettered scope, within the limits of the law, for the exercise of its duties of regulation in the interests of the public.

In England, it has been held that, where a criminal remedy is imposed for breach of secrecy by a regulatory authority supervising investment

businesses, a private party injured by this disclosure does not have a private right to sue the regulator for damages. The only available remedy to the injured party is to seek judicial review of any anticipated disclosure (which is too late if the disclosure has already been made).[168]

A key question is whether supervisory information is immune from compulsory disclosure in civil litigation on the grounds of public interest—originating in the proposition that matters of defense and other essential country communications should not be disclosed in courts at the behest of private litigants.

The question of whether information supplied by a regulated bank to a supervising authority is immune from disclosure in civil litigation has been litigated in England. In *Kaufman v. Crédit Lyonnais*,[169] the bank supplied documents to an investment business regulatory authority in the United Kingdom. The plaintiff alleged breach of duty in relation to the bank's management of his investments and requested disclosure of the documents supplied by the bank to the regulator in the hope that these documents might disclose evidence to support his case. The bank maintained that the documents were protected by public immunity. In other words, disclosure was contrary to the public interest. The court held that the bank was not entitled to withhold discovery of a class of documents on the ground of public immunity. The purpose of the regulatory scheme was the protection of investors. This purpose overrode the desire to encourage candor between the regulator and the regulated.

In France, banking secrecy cannot be invoked against the banking supervisory authorities under Article 57(2) of the banking law of January 24, 1984.[170] Similarly, secrecy cannot be invoked against the Securities Exchange Commission who, by a law of 1967, modified in 1989,[171] can have all documents of whatever nature handed to it and obtain copies thereof. The Commission can summon and hear any person who is likely to provide information. The Commission's authorities also may enter premises. Professional secrecy cannot be invoked against it.

In Germany, the Banking Act (*Kreditwesengesetz*) gives the bank supervisory authorities the right to demand information on any business matter, request the submission of books and documents, and carry out investigations without giving specific reasons.[172] The supervisors may enter the bank's offices. They may only demand information that is necessary to fulfill the tasks provided in the Banking Act. Specific reporting requirements exist to satisfy the various rules about exposures and the like.

In Greece, the strict banking secrecy is not operative against the Bank of Greece, the courts, and investigating parliamentary committees concerned with the control of credit institutions in the discharge of their functions. A

1989 law allowed the lifting of secrecy for banks placed under compulsory governorship and for commencement of criminal prosecutions against the managements of banks relating to their administration where the crime "has aroused a public outcry"—a reference to the Bank of Crete case.[173]

In Japan, the usual exception in favor of the banking supervisors exists, but it is subject to certain exceptions. In Switzerland, Swiss banks and Swiss branches of foreign banks must provide all information concerning their Swiss business to the country's regulatory authorities. The Swiss regulatory authorities may use the information disclosed to them only within the scope of their statutory functions. Employees of the regulatory authorities are strictly bound by secrecy. Other authorities, such as the Zurich Stock Exchange Commission, may also be bound by secrecy.

International Supervision

Banking is an international business that knows no boundaries. Major international banks commonly have branches and subsidiaries abroad. Effective supervision requires that banks be supervised as a whole.

A number of issues are relevant to supervisory information. These issues include the conflict between flexible discretions and the straightjacket of black-letter law; the desire to ensure that employees of supervisors, as overseers of banking integrity, should not themselves be the source of leaks;[174] the risks imposed by disclosing information to supervisors in countries with a lax view of bank secrecy; the risks imposed by legal actions against supervisors, blaming them if a bank should fail ("big pocket" liability); the need to handle potential bank failures sensitively to avoid either making things worse or provoking systemic cascades; and the objection in some countries to the sharing of information with the fiscal authorities or authorities in the nonfinancial sector.

The usual pattern is that the national banking legislation permits the supervisors to disclose information they are entitled to gather from national banks to foreign supervisors, generally on condition of secrecy. Practice differs as to whether nonbanking supervisors, such as supervisors of insurers, securities firms, or general corporations, can receive information and whether the receiving supervisors can share this information with other authorities, for example, the fiscal authorities. Often the latter requires a consent from the communicating authority.

European Union

In the European Union, banks have a single passport to operate throughout the European Union. A system of allocating the main super-

visory duty to the home country's supervisors also exists. This arrangement relies on an exchange of information.[175]

Under Article 12(1) of the First Banking Directive, employees of competent authorities, as well as their auditors and experts, are bound by professional secrecy covering confidential information acquired in the course of their duties.[176] Competent authorities receiving confidential information may use it only in the course of their duties (i) for authorization, (ii) for financial supervision, (iii) to impose sanctions, (iv) in appeals against regulator's decisions, and (v) in court proceedings pursuant to directives on credit institutions.[177]

Exceptions (Gateways)

Numerous exceptions, also known as "gateways," permit the disclosure of confidential information. The exceptions, which flow from Article 12(1) of the First Banking Directive, include nonconfidential information; information not acquired in the course of competent authorities' duties; information in summary or collective form, such that individual institutions cannot be identified; information relating to cases covered by the criminal law;[178] and information that does not concern third parties involved in rescue attempts. In the latter case, such information may be divulged in civil and commercial proceedings when a credit institution has been declared bankrupt or is being wound up. Another exception allows competent authorities to exchange information in accordance with the directives applicable to credit institutions.

Under Article 12(2), the information received is subject to Article 12(1) secrecy conditions and to Article 12(4) restricted uses of the information.

Article 12(3) permits member states to conclude cooperation agreements that provide for the exchange of information with the competent authorities of third countries only if the information is subject to guarantees of secrecy at least equivalent to those in Article 12. This safeguard is to protect information disclosed to countries with lax secrecy rules.

Article 12(5) allows exchanges between competent authorities in one or more member states and regulators of other financial organizations, such as insurers and financial markets. This article also permits exchanges between competent authorities and (i) statutory auditors and (ii) bodies involved in the insolvency proceedings affecting credit institutions. The exchange, however, must be in the discharge of their supervisory functions. Information received is subject to the Article 12(1) secrecy duty. Article 12(5) also permits the disclosure in member states or between member states to deposit guarantee schemes of information necessary for

the exercise of their functions. Again, information received is subject to the Article 12(1) secrecy duty.

Exchanges of information between competent authorities and authorities responsible for overseeing the insolvency of financial undertakings, or authorities responsible for overseeing statutory auditors of insurers, credit institutions, investment firms, and other financial institutions, may occur at the option of member states. The information obtained, however, must be used only for the overseeing task, subject to the Article 12(1) secrecy duty, and disclosed only with the agreement of the disclosing competent authority in that member state.

Under Article 12(5b), exchange of information between competent authorities and authorities responsible for the detection and investigation of breaches of company law (including private sector appointees), with the aim of strengthening the stability and integrity of the financial system and subject to similar conditions as in the previous exception, may occur at the option of the member state.

Article 12(6) permits disclosure to central banks, monetary authorities, and public authorities overseeing payment systems for the performance of their tasks. Information is subject to the Article 12(1) secrecy duties.

Member states may disclose information to central government departments responsible for legislation in the financial and insurance sectors. Disclosure to inspectors acting on behalf of those departments is also permitted, but only where necessary for reasons of prudential control. This probably includes parliamentary commissions of enquiry. Information may only be disclosed under the exceptions in Article 12(2) (exchanges between competent authorities) and Article 12(5) (disclosure to other regulators) with the consent of the disclosing competent authority.

Under Article 12(8), disclosure to recognized member states' clearing or settlement systems may occur to ensure their proper functioning in relation to defaults or potential defaults by market participants. Under this exception, however, disclosure of information permitted to be exchanged between member state competent authorities by Article 12(2) requires the consent of the disclosing competent authorities.

Auditors, and the like, must disclose to the competent authorities facts of which they are aware and which are liable to show material breaches of authorization conditions or rules that specifically govern the activities of finance undertakings, affect the continuous functioning of the financial undertakings, or lead to refusal to certify the accounts or to reservations. This duty also applies to controlling affiliates as defined. Auditors disclosing in good faith are protected (including against breach of secrecy contracts or laws).

There is no exception for other national legal requirements, such as discovery in ordinary civil litigation. The closing of this loophole resulted from the holding in *Municipality of Hillegom v. Hillenius*,[179] which interpreted a previous version of Article 12. In this case, a Dutch municipality lost money with a branch of a foreign bank that failed. They alleged that the Dutch central bank should have acted on information received from supervisors in other member states. The Dutch supervisor refused to answer questions, as required by Dutch rules on compulsory evidence. At that time, the unamended Article 12(1) allowed disclosure "by virtue of provisions laid down by law." The court seems to have held that member states can allow exceptions subject to the overall objectives of the First Banking Directive. In other words, a fettered discretion to opt out exists.

This list of exceptions is probably exhaustive. The possibility of disclosure, however, also exists under other directives, for instance the Money-Laundering Directive.[180]

Country Examples

In Britain, Section 84(6) of the Bank Act, 1987, allows disclosure to foreign supervisors in the fields of banking (and other credit or deposit forms), insurance, investment business, and insider dealing for the purposes of their functions. Under Section 86, incoming information is protected by secrecy roughly corresponding to the secrecy imposed on the Bank of England.

However, in Britain the courts allowed a private bank to provide information to a foreign supervisor outside the statutory scheme in two cases. First, in *Libyan Arab Foreign Bank v. Bankers Trust Co.*,[181] the United States imposed a worldwide freeze on dealings with Libya. The London branch of Bankers Trust disclosed details of the Libyan Arab Foreign Bank's London account to the Federal Reserve in New York. The court held tentatively that a bank might have a higher public duty in the circumstances to disclose to its principal supervisor. Second, in *Femis-Bank Anguilla Ltd. v. Lazar*,[182] the court refused to enjoin a party alleging dishonesty and breach of regulation by an offshore bank from providing information to overseas regulatory authorities, since a public interest existed in determining the credibility of the allegations.

The willingness of the English courts to permit disclosure to foreign authorities in the case of banking supervision is particularly noticeable, especially where fraud is alleged. In *Bank of Crete SA v. Koskotas (No. 2)*,[183] the chief executive of a Greek bank allegedly misappropriated $200 million. Court orders were made in England ordering various banks to disclose to the Bank of Crete information relating to customers of the banks. The court ordered that the information could only be used for the Bank of Crete actions against the defendants in England. However, the supervisory

authorities in Greece were also carrying out an investigation into the alleged misappropriation and required disclosure of the information. The court permitted the Bank of Crete to supply the information to any person to whom it was legally compelled, under the law of a foreign jurisdiction, to provide the information. In these "exceptional circumstances," the court would not put the Bank of Crete in the impossible position of either infringing the court's disclosure order or else contravening Greek law.

In Denmark, banks must release to the supervisory authorities all necessary information. The usual secrecy duty on employees of the authority backed by criminal sanctions exists, but the Financial Supervisory Board can transfer the confidential information to other public authorities, such as the police, certain courts, and foreign central banks, subject again to confidentiality.

In Finland, the Banking Supervision Authority has a right to inspect all documents concerning the bank under inspection as well as customer information. The authorities can inspect branches abroad, if locally permitted, and can exchange information with a foreign supervisor, subject to reciprocity.

In Luxembourg, the Luxembourg Monetary Institute (IML) has wide powers to investigate credit establishments by virtue of a 1984 law.[184] The IML can communicate information regarding supervision of the financial sector to foreign supervisory authorities, but it is obliged to refuse communication if the foreign authority is neither required to observe professional secrecy nor required to use the information exclusively for the purposes of supervising credit establishments.

In Switzerland, the Federal Law on Banks and Savings Banks of 1934 (as amended in 1995) allows the Federal Banking Commission to transmit confidential information and documents to foreign supervisory authorities, provided (i) the information is used exclusively to supervise directly banks or other supervised financial institutions, (ii) the foreign authorities are bound by official or professional secrecy, and (iii) the information is not passed on to other supervisory authorities without the prior consent of the Federal Banking Commission or by virtue of a general authorization under an international treaty.[185] The transmittal of information to prosecution authorities is not permitted if legal assistance in criminal matters is not available.

To the extent information transmitted to foreign supervisory authorities relates to individual banking clients, the transfer of such information is subject to a formal decision. A bank customer may appeal this decision. Provisions for consolidated supervision altering the provision of information to foreign parties for supervisory principles also exist, subject to conditions.

Disclosure to Supervisors of Securities Firms

Generally, the degree to which banking secrecy is overridden in the case of securities regulation is similar to that applying to bank supervision, although it may well be that the securities legislation lags behind banking regulation in many countries. This topic is not dealt with in detail in this chapter.

In Britain, the Financial Services Act, 1986, as amended,[186] contains extensive powers of investigation by the various supervisory authorities very much along the lines of the banking powers. In Hong Kong, Section 127(1) of Chapter 333 of the Securities Ordinance empowers the Hong Kong Securities and Futures Commission to appoint an inspector to investigate fraud and misfeasance in relation to securities dealing and the giving of investment advice.[187] An inspector also may require a bank to produce documents relating to a matter under investigation. English-based jurisdictions appear on the whole not to regard U.S. grand jury proceedings as a proper proceeding leading to a trial, but rather as a non-admissible fishing expedition.[188]

Corporate Disclosure and Governance

Corporate Disclosure and Audit

In developed jurisdictions, corporations, including banks, that issue securities to the public or list their securities must provide information necessary to enable investors to make an informed judgment about the worth of the securities. There may also be disclosure rules directed toward the prevention of mismanagement and the disclosure of concealed ownership.

Most of the information is nonspecific, so that particular customers are not identified. However, because auditors must often now verify a bank's compliance with banking laws, including those related to financial supervision, disclosure is unavoidable. Bank auditors are invariably subject to a secrecy duty as an extension of the bank secrecy duty (as in Switzerland) or by virtue of their professional rules.

The main issues of disclosure are public financial statements of banks, prospectus and listing disclosure for securities issued by banks, official corporate investigations for suspected mismanagement, disclosure of beneficial holdings in public companies above a certain threshold,[189] and investigations into suspected corporate offenses.[190]

Official investigations into corporations for suspected mismanagement will trump bank secrecy in Britain, Ireland, and Australia in certain

instances. Banks themselves are usually subject to rigorous investigation procedures under banking legislation. In Britain, bank secrecy may be overridden by investigations into the affairs of all (public) corporations including banks.[191] In Ireland, the Companies Act, 1990,[192] provides in similar terms for inspections where there are circumstances suggesting, among other things, that the affairs of the company are being conducted fraudulently or for an unlawful purpose. The inspectors have powers to call for information and documents. These powers override bank secrecy. In *Chestvale Properties Ltd. v. Glackin*,[193] the court held that, although inspectors have extensive powers, they must adhere to the rules of natural and constitutional justice when exercising functions of a judicial nature that are not merely investigative. Among the principles of natural justice are the rules against bias and the right of each party to be heard. In Australia, the wide powers under the Securities Commission Act of 1989[194] appear to allow fishing expeditions.[195]

In Switzerland, the management of a Swiss branch or subsidiary of a foreign bank must only furnish general information that would not entail a breach of bank secrecy to the auditors. In the case of an unrestricted audit, the auditors are deemed mandatories of the Swiss bank. This designation subjects them to the Swiss secrecy law.

Disclosure to Tax Authorities

National Taxes

Obviously, there is no secrecy in relation to the bank's own tax affairs. Fiscal authorities are subject to secrecy duties in most developed countries, for example, the duties imposed under official secrets legislation.

Most jurisdictions permit disclosure to the domestic tax authorities in relation to the tax affairs of customers. Often banks are under a positive duty to report certain information (for example, the income earned by customers on their accounts and securities). In many countries, the tax authorities have agreed to voluntary codes limiting their admittedly draconian powers of surveillance and search and seizure. Vetting procedures as a buffer between banks and the authorities may exist.

In some countries, all transactions above a certain size must be reported in order to prevent tax evasion.[196] Apart from tax haven countries, one of the most restrictive countries appears to be Greece, followed by Luxembourg, Austria, and Switzerland. Tax legislation is extremely ephemeral. It is difficult to pin down the up-to-date position in any particular case.

In Australia, the tax authorities' powers are extensive. It has been held that the duty of disclosure does not apply if the bank account benefits from legal professional privilege, although this is a narrow exception because the accounts must be the subject of legal advice.[197] Australia does not permit general fishing expeditions by the tax authorities.[198]

In Austria, the ability of the fiscal authorities to obtain information is limited by several factors. These factors include (i) there must be an offense, not a mere irregularity, (ii) the proceedings must have been instituted, (iii) information must be relevant to the offense, and (iv) the suspicion sought to be confirmed must be well founded and reasonable.

In Britain, the Taxes Management Act, 1970,[199] gives wide powers to the revenue authorities to call for information and returns, including interest earned. The Income and Corporation Taxes Act, 1988,[200] gives the Commissioner of Inland Revenue the power to call for information relating to the transfer of assets abroad. The court will disallow excessive requests.[201]

In Canada, taxing statutes are both federal and provincial. Under federal legislation, Revenue Canada has wide powers to examine third-party books and records, including bank accounts, even if this leads to the disclosure of information about the bank's customers who are not themselves under investigation.[202] Revenue Canada has a voluntary code of conduct. In Denmark, fiscal authorities have wide powers of access to bank information. There are somewhat similar provisions in Finland.

In France, the Tax Procedure Code provides that all organizations must provide tax information on request without invoking professional secrecy. The courts have held that secrecy cannot be invoked against tax authorities.[203] The tax authorities have a voluntary code of restraint. Similar provisions apply to customs authorities.

In Germany, distinctions are made between the types of tax proceedings.[204] Banking secrecy is overridden when the tax authorities have the right to information, but there is a detailed statutory code for the protection of bank customers. The widest right to information is under the Inheritance Tax Law.[205]

In Greece, the tax authorities are not permitted to lift bank secrecy as regards bank deposits. This approach is the better view, but few countries have adopted it. An Athens appeals court held that the country is not permitted to seize a deposit to satisfy an income tax liability.[206] In another case, the tax authorities applied for information from a Greek bank regarding amounts collected by shopkeeper customers through sales under a credit card. The court held that the bank need not supply the

information because secrecy of deposits also included operations on the account such as withdrawals.[207]

Hungary and Poland proposed, in the mid-1990s, to give the tax authorities access to bank information.

In Italy, the powers of tax investigation into bank accounts were substantially widened in 1992.[208] The tax authorities now have the power to call for documents and perform inspections, as well as lift bank secrecy, if there is an audit of the taxpayer, regardless of the nature of the suspected violation, the amounts involved, or any other circumstances. No court order is required. However, information may be sought only through the head office of a bank in order to prevent undesirable rumors around investigated customers. Banks must give notice of the investigation to customers as a matter of private contract law. The tax authorities are subject to duties of confidence.

In Luxembourg, the tax authorities' rights are very restricted. A Grand-Ducal Decree of March 24, 1989 provides that the domestic tax authorities are not permitted to seek information from banks concerning their customers.[209] There are a few exceptions to this rule. These exceptions include the inheritance tax, the assessment of registration or mortgage duties, and the value-added tax. However, in effect, the 1989 Decree insulated banking secrecy from the domestic tax authorities. Generally, in Luxembourg banking secrecy is extremely tight compared to other jurisdictions. This is so even though German fiscal legislation introduced in Luxembourg in World War II prohibits the keeping of professional secrets from the tax administration. The tax authorities have never invoked this legislation and merely keep it for the purposes of enabling mutual assistance with the tax authorities of other countries.

In Mexico, the text on banking secrecy in Article 117 of the Credit Institutions Law of 1990 permits disclosure pursuant to a request of the federal tax authorities through the National Banking Commission for tax purposes.

In the Netherlands, the tax authorities have wide powers to override banking secrecy under Article 49 of the General Law of the Kingdom's Taxes. Evidently, the tax authorities exercise their powers with restraint. Also, a detailed code of conduct, initially inaugurated in 1984, exists.

In New Zealand, the Inland Revenue Department Act, 1974,[210] gives the New Zealand tax authorities extensive powers to gather information. In *New Zealand Stock Exchange v. Commissioner of Inland Revenue,*[211] the New Zealand revenue authorities required the stock exchange to produce a list of their largest clients and details of those clients' purchases and sales of shares, and required a bank to produce the names and

details of bank customers who had bought and sold commercial bills. These were general inquiries. They did not specify particular customers, nor was it alleged that there was any fraud or evasion. The court held that, by the plain wording of the statute, the tax authorities were entitled to the information.

In Portugal, there is no compulsory disclosure to the tax authorities. In South Korea, secrecy is lifted if the tax authorities request information under the tax laws.

In Spain, a tussle in the courts between the tax authorities and private citizens occurred in the 1980s. The citizen's view that the tax authorities were not entitled to lift bank secrecy on the grounds that it was unconstitutional did not succeed.[212] In Sweden, the tax authorities' powers are so wide that it has been suggested that bank secrecy does not exist against them.

In Switzerland, there are distinctions between the federal, cantonal, and municipal tax jurisdictions. Generally, bank secrecy is often observed in relation to tax evasion. However, it is not observed in the case of serious tax fraud.[213] Bank employees must testify in criminal proceedings regarding evasion of stamp duties, withholding taxes, turnover taxes, and customs duties.

In the United States, the Supreme Court has held that the tax authorities' use of bank records to convict a defendant, among other things, of conspiring to defraud the government of tax revenues, pursuant to an allegedly defective subpoena *duces tecum* did not infringe the Fourth Amendment's protections against unreasonable searches and seizures.[214]

International Cooperation

Internationally, exchanges of information between national fiscal authorities generally require a treaty. Many of these treaties now exist. The general rule still follows Lord Mansfield's dictum in 1775, when he said that "no country ever takes notice of the revenue laws of another."[215]

Practice varies enormously on the degree to which national fiscal authorities can override local bank secrecy at the request of a foreign fiscal authority. International judicial collisions regarding this issue have been common.

An English court resolved this issue in *X AG v. A Bank*[216] by refusing to override local bank secrecy for a U.S. court proceeding. In this case, a U.S. grand jury subpoena, backed by a New York court order, ordered a U.S. bank to disclose all account documents at the London branch of the bank in respect of a Swiss company. The U.S. proceedings concerned

alleged U.S. tax evasion. The court concluded that the U.S. order was, by English standards, excessive, and the London branch would not be permitted to breach English bank secrecy by disclosure.

A court in Hong Kong used a different solution to this problem by issuing an interlocutory injunction to avoid a breach of bank secrecy. In *FDC Co. Ltd. v. The Chase Manhattan Bank NA*,[217] the U.S. Internal Revenue Service was investigating the tax liability of Mr. Gucci and the Gucci company. A U.S. court issued a subpoena on the bank in the United States. The court in Hong Kong restrained the bank's local branch from disclosing documents or information to comply with the U.S. subpoena by issuing an interlocutory injunction.

An English appellate court solved the same issue in *R v. Grossman*[218] by refusing to order the English head office of Barclays Bank to produce documents of its customer maintained at the bank's Isle of Man branch in connection with a tax investigation.

In two German decisions of the District Court of Kiel,[219] the court held that compliance with local bank secrecy trumped compliance with subpoenas issued by a Michigan grand jury. The subpoenas ordered the branch of the bank in Kiel, which had a branch in New York, to produce customer documents. The order conflicted with German bank secrecy. The court enjoined the bank from divulging the documents. Subsequently, the U.S. authorities filed a proper request for judicial assistance through the competent German authorities. This request was successful.

Tax Treaties

The OECD Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, a leading model treaty, provides in Article 26 for the exchange of information to carry out the provisions of the Convention.[220] Exchanged information has the same secrecy treatment that applies under the law of the receiving country, and can only be disclosed (broadly) to fiscal authorities, including enforcing courts. No contracting country need supply information that is, among other things, a commercial or professional secret. Bank secrecy is not specifically mentioned, but countries can, and do, protect bank secrecy. On the other hand, many treaties give greater powers to the tax authorities.

Extensive case law on these treaties exists. Thus, in 1986, a Hamburg court held that, as a result of the Germany-Australia treaty, a German bank must reveal details of clients' accounts to the German tax authorities because these authorities were responding to a request from the

Australian tax authorities. Bank confidentiality was not a "professional secret" within the treaty. In 1970, the Swiss Federal Court held that Swiss bank secrecy must be relaxed and information furnished under the Switzerland-United States Treaty if the Swiss tax authorities have a well-founded suspicion that a U.S. tax fraud has been committed. In 1981, five Florida banks were compelled by the U.S. Internal Revenue Service to produce information for Canada under a treaty, but a similar action in 1989 failed. In 1980, a Brussels court held that a Belgian company could sue for damages when the Belgian authorities improperly gave information to the Italian tax authorities on "secret" commissions paid to Italian residents, as a result of which the Italians reduced their purchases.

There are EC Directives on mutual assistance in the field of direct taxation[221] and on value-added taxes (VAT).[222] The EC Directive on mutual assistance in the field of direct taxation serves as an example. The recitals provide that tax evasion and tax avoidance across the frontiers of member states lead to budget losses and violations of the principle of fair taxation. These practices are liable to bring about distortions of capital movements, hence international measures are necessary to deal with this international problem.

Article 1 provides that "the competent authorities of the Member States shall exchange any information that may enable them to effect a correct assessment of taxes on income and capital." Articles 2, 3, and 4 address the exchange of information by request and the automatic and spontaneous exchange of information. Pursuant to Article 2(2), "the competent authority of the requested Member State shall arrange for the conduct of any enquiries necessary to obtain [the requested] information." It follows that if banks are domestically required to disclose information at the request of member states, that information may find its way to another member state. Member states, such as the United Kingdom, do provide for the provision of information by banks to the fiscal authorities.

Under Article 7, all information exchanged shall be kept secret in the receiving state in the same manner as information received under its domestic legislation. The standard is that of the receiving state, which may have standards that are more lax than the communicating state. However, there are safeguards in Article 7, which broadly requires that the information be made available only to the fiscal authorities or in connection with enforcing judicial or administrative proceedings. If a member state has narrower limits, then the communicating state can require the receiving state to respect the narrower limit. Communicating authorities, however, may allow information to be used for other purposes in the receiving state if this would be allowed under the laws of the communicating state. Communicating competent authorities can allow receiving competent authorities to pass the information to third-party countries.

However, a general override in Article 8 may respect banking secrecy. An authority need not carry out enquiries or provide information if those activities would be prevented by its legal regime in relation to itself. Moreover, Article 8 provides that "information may be refused where it would lead to the disclosure of a commercial, industrial, or professional secret or of a commercial process, or of information whose disclosure would be contrary to public policy." This language is similar to the OECD model tax treaty where there is case law that "professional secret" does not necessarily include bankers secrecy.[223] Finally, under Article 8, an authority can "refuse to provide information where [a receiving state] is unable, for practical or legal reasons, to provide similar information"; in other words, where no reciprocity between states exists.

In implementing the EC Directive's provisions for the exchange of tax information, the tax authorities in Greece are not permitted to provide assistance and information on bank deposits to the tax authorities in other member states.

Luxembourg has many double taxation treaties but will not divulge information covered by Luxembourg banking secrecy under these treaties. Under Article 8 of the EC Directive on mutual assistance in the field of direct taxation,[224] a member state may refuse to seek information on behalf of another member state's authority if its domestic authorities would not seek the same information under their usual practice. Luxembourg has always used this provision to refuse exchanges.

In Switzerland, there can be no legal assistance involving fiscal information if there is no treaty. The treaties with France, Germany, Denmark, Great Britain, and the United States protect bank secrecy. Serious tax frauds, however, may permit mutual assistance under the Swiss Legal Assistance Act of 1981.[225]

Tax Havens

Tax havens are countries with zero or low taxes. Some of these havens have special legislation permitting the establishment of local business companies and trusts that are not permitted to carry on business locally, but these companies and trusts maintain secrecy by avoiding public disclosure of financial statements. These tax havens are mainly small economies. Other countries grant special exemptions to encourage investment.

Commonly, individuals and businesses seek to place their assets in these countries to escape high taxes in their own countries. Tax avoidance legislation seeks to counter this practice by taxing income earned abroad, such as royalties and patents (even though not repatriated), and attacking

transfer pricing.[226] Often the use of tax havens is perfectly legitimate. For example, certain offshore investment companies and trusts, captive insurance companies, and employment companies, especially in shipping, represent legitimate uses of tax havens. In other cases, tax havens have been used improperly to evade taxes. The "respectable" tax havens have been diligent to preserve their reputations.

Tax haven countries must be politically stable, free of an inclination to expropriate, and free from exchange controls. These factors are not considered by potential customers to be satisfied in the case of numerous countries that might otherwise qualify, so the list of widely used tax havens is not large. Some widely used tax havens are the British Virgin Islands, the Cayman Islands, Gibraltar, Grenada, the Isle of Man, and Jersey.

The British Virgin Islands is a U.K. territory with limited internal legislative powers. The common law of England applies. Accordingly, the English rules of banking secrecy are in force, except as modified by statute. Thus, the *Tournier* rules apply.[227] There is a local equivalent of the U.K. Bankers' Books Evidence Act.[228] The Evidence (Proceedings in Foreign Jurisdictions) Act of 1988[229] is similar to the U.K. legislation in giving effect to the principles of the 1970 Hague Convention.[230] The Drug Trafficking Offences Act, 1992,[231] is based on the United Kingdom's 1986 Act. The Mutual Legal Assistance (United States of America) Act[232] provides for mutual assistance under the treaty in relation to specific crimes, including racketeering, drug trafficking, insider trading, and fraudulent securities practices. Bank secrecy is overridden in relation to the crimes concerned, including investigations, but requesting parties must not use any information obtained under the treaty for any purposes other than the investigation, prosecution, or suppression of the crimes concerned without the prior consent of the requested party.

In the Cayman Islands (a British dependent territory in the Caribbean and a major international financial center with hundreds of banks), the *Tournier* case applies.[233] This is backed up by the Confidential Relationships (Preservation) Law, 1976,[234] which makes a breach of secrecy a criminal offense subject to exceptions.[235] The Cayman Islands also has the Mutual Legal Assistance Treaty of 1986 with the United States, through the United Kingdom, covering certain criminal matters but specifically excluding tax matters and tax enquiries.[236]

Gibraltar is a U.K. dependent territory and a dependent territory of the European Union under Article 227(4) of the Treaty of Rome. EC banking and other directives apply, but the VAT Directive and certain others do not.[237]

In Grenada, which gained its independence in 1974, *Tournier* applies,[238] as well as the Evidence Act (based on the British Bankers' Books Evidence Act, 1879), the Bankruptcy Act (based on the British Bankruptcy Act, 1883), and the International Companies Act (based on the British 1908 version).[239] Tax authorities have wide powers. United States-Grenada (Taxes Exchange of Information) Act, 1987, provides for mutual assistance in tax matters.[240] The Banking Act, 1988, contains the usual disclosure powers.[241] The International Companies Act, 1989, provides for the complete secrecy of offshore companies, except for court disclosure orders relative to the investigation of Grenadian crimes or by other court orders, or under the U.S. treaty.[242]

In the Isle of Man, a U.K. Crown dependency, the EC directives on financial institutions do not apply. *Tournier* [243] probably applies, as well as the Bankers' Books Evidence Act, 1935, on English lines, and the Banking Act, 1975, which allows exchange of supervisory information with foreign authorities, but not tax authorities.[244]

On the other hand, Jersey is a U.K. Crown dependency that is not strictly a tax haven. It is not a member of the European Union, but certain Treaty of Rome provisions apply. EC tax and financial institution directives do not apply; *Tournier* applies.[245] The following acts are on British lines: Bankers' Books Evidence (Jersey) Law, 1986; Drug Trafficking Offences (Jersey) Law, 1988; Investigation of Fraud (Jersey) Law, 1991; Evidence (Proceedings in Other Jurisdictions) (Jersey) Order, 1983; Company Securities (Insider Dealing) Law, 1988; Banking Business (Jersey) Law, 1991, and the Code on Money Laundering, which is patterned on the 1988 Basle Statement of Principles.[246] These laws provide fairly wide powers in favor of tax authorities.

Disclosure in Civil Litigation

Domestic Civil Litigation

Civil litigation requires opposing parties to disclose their evidence to the other before the trial so that a party is not ambushed. Parties must cooperate in the search for the truth. However, court rules often prevent fishing expeditions, harassment, and oppressive or irrelevant disclosure.

Pretrial Discovery

As regards pretrial discovery, the main categories are (i) countries that allow wide pretrial discovery, (ii) countries that compel a degree of pretrial discovery but do not permit fishing expeditions and are otherwise

restrictive, (iii) countries that do not allow pretrial discovery, and (iv) countries that have not addressed the issue.

The United States fits into the first category. It allows wide pretrial discovery, including the asking of questions on any matter relevant to the subject matter involved in the pending action, and it is not ground for objection that the information sought will be inadmissible at the trial if this information seems reasonably calculated to lead to the discovery of admissible evidence.[247] The difference between English and U.S. procedures was discussed in *Radio Corp. of America v. Rauland Corp.*[248] and recognized by the U.S. Supreme Court in *Société Nationale Industrielle Aérospatiale and Société de Construction d'Avions de Tourisme v. U.S. District Court for Southern District of Iowa.*[249] "It is well known that the scope of American discovery is often significantly broader than is permitted in other jurisdictions . . . ."[250] It is not necessary to know of the existence of documents in advance. The rules allow the discovery of anything that is not privileged and that may lead to the discovery of admissible evidence. A general description will suffice, subject to protections for discovery that is inappropriate or abusive.

The English-based common law countries fit into the second category. These countries compel a degree of pretrial discovery but do not permit fishing expeditions and otherwise are restrictive. This approach, however, applies only between the parties. Banks are not usually subjected to pretrial discovery in litigation in which they are not a party.

Most developed civil law jurisdictions, such as Germany, France, and the Netherlands, fall into the third category. These countries do not allow pretrial discovery. They object to the burden of disclosing vast numbers of documents, many of which are irrelevant, in order to find evidence. Indirect pressure to produce evidence exists, because the court may draw adverse conclusions if a party fails to produce.

The fourth category consists of countries that do not have highly developed court procedural rules. These jurisdictions do not have an opinion on pretrial discovery.

English-Influenced Jurisdictions

The position in England is illustrative of the position in many English-influenced countries. First, pretrial discovery is permitted only between the litigants, who must produce all documents in their possession, custody, or power that are relevant to the issues. Third parties, such as banks, are mere witnesses. They can be compelled by subpoena to testify in court, but discovery is not available against them because they are not party to the dispute and should not be subjected to burdensome involve-

ment in disputes between others. There are exceptions—especially where the discovery is necessary to trace assets spirited away by fraud or mistakenly paid away.[251] Second, by virtue of Section 7 of the Bankers' Books Evidence Act, 1879, banks can be compelled by subpoena to testify and produce documents, but only in the actual proceedings. There are procedures whereby a copy of a banker's books is admissible in evidence.[252] This rule of convenience allows banks to avoid attending court.

The Bankers' Books Evidence Act is adopted in numerous English-based countries, including the Caribbean islands, such as the British Virgin Islands.[253] Singapore also has a version of the Bankers' Books Evidence Act.[254]

As previously mentioned, disclosure is usually available only as regards the bank of the other party to the proceedings, not third parties, unless, for example, the third party's account in reality contains money of the defendant or shows the location of his assets.[255]

Banks must also comply with court subpoenas in the same way as any other witness, but the court will require that the bank supply relevant evidence to satisfy the subpoena.[256] In the Irish case of *Staunton v. Counihan*,[257] a guarantor guaranteed the debt of a company and executed a charge on property to secure the guarantee. Following a claim on the guarantee by the creditor, the guarantor alleged that no debt was due by the company as principal debtor. The creditor sought to take copies of all entries in the bank account of the debtor company at the time of the execution of the charge. The court held that the debtor company was not a party to the proceedings, and so great caution was required in calling for inspection under Section 7 of the Bankers' Books Evidence Act, 1879.[258] The creditor's claim did not essentially depend upon the entries in the bank account of the company and must be proved by other means. The lifting of the company's bank secrecy was refused. Similarly, in Australia, excessive subpoenas are treated as a serious abuse of the process of the court.[259]

In England, it has been held that a bank might sometimes be obliged to inform a customer of the receipt of a subpoena, but a bank need not do more than use its best endeavors to inform the customer if the bank is ordered to produce details of the customer's account in court. In *Robertson v. Canadian Imperial Bank of Commerce*,[260] a lender claimed that he had made a loan to a borrower who wanted to pay off a debt to his brother. So the lender gave the borrower a check in favor of the brother. The borrower denied receiving the loan. The lawyer got an order for the discovery of the brother's bank statements. The bank tried to contact the brother but failed and so produced the bank statements in court. These statements revealed the amount of the loan. They also

revealed that the brother had an overdraft, which, he claimed, wounded his feelings and injured his credit. This revelation was irrelevant to the proceedings. The court concluded that the brother had no claim. The bank had been ordered by the court to produce the statements. At most, the bank had an obligation to use best endeavors to inform the customer of the subpoena. In any event, the brother had suffered no loss.

In New Zealand, the courts are similarly reluctant to order the production of banking records of a person who is not a party to the litigation. In *Allingham v. Bank of New Zealand*,[261] the customer alleged that the bank had closed out foreign exchange contracts at a time that was disadvantageous to the customer. The customer wished to show that the bank had pursued a deliberate policy of prejudicing smaller clients by closing out their contracts at different times in order to protect the interests of larger clients. The customer, therefore, sought discovery of bank documents that would reveal the identity of other customers who had allegedly suffered similar losses and the extent of those losses. The court held that the customer was not entitled to information about the names, transactions, or losses of other customers.

Other Country Examples

In Denmark, the procedural code provides that the court can determine that a witness shall be excluded with regard to facts that they should treat as confidential where confidentiality is important. However, in one case in 1979 a court ruled that a creditor should not be barred from obtaining information from employees in a bank regarding a debtor's assets at the bank.[262]

In Germany, a "business secrets privilege" exempts a witness from disclosing information that would constitute the divulgence of a business secret—an all-embracing concept. The German courts will not accept protective orders whereby the parties to whom the disclosure is made will keep the information confidential. The exemption for confidential information is to be found in Paragraphs 383 and 384 of the Code of Civil Procedure. This view is strongly held in relation to other areas of German law. For example, banks can refuse to testify in insolvency, labor court, and social court proceedings, as well as administrative court proceedings, if the information is confidential.

In France, it appears that the banking secrecy law set out in Article 57 of the Banking Law of 1984 [263] overrides provisions of the new Code of Civil Procedure providing for compulsory disclosure.

Luxembourg is also one of the few countries that has not overridden bank secrecy in the case of civil litigation. The Supreme Court of

Luxembourg has decided on several occasions that any person required to observe professional secrecy under Article 458 of the Penal Code may disclose confidential information when he is required to testify, but the court may not oblige him to disclose.[264]

In Mexico, Article 117 of the Credit Institutions Law of 1991 states that bank secrecy can be overridden where the information has been requested by a court of law pursuant to a ruling issued in a legal action where the holder of title is either plaintiff or defendant.

In the Netherlands, bankers must give testimony in civil proceedings, but they can testify only as to facts known to them from their own observation. No obligation to produce documents or other records exists. Only the actual litigating parties have to produce documents. In Portugal, bank secrecy cannot be overridden by mandatory testimony by a third-party bank in civil proceedings.[265]

In Singapore, civil proceedings can be held ***in camera*** so as to preserve bank secrecy.[266] In South Korea, Article 318 of the Civil Procedure Code permits disclosure of confidential information if necessary for evidentiary purposes.

In Spain, Article 603 of the Civil Procedural Law provides that a judge can require documents from a person who is not a party to the proceedings, provided this is requested by one of the parties to the proceedings, and the court decides that the documents are relevant to the decision.[267] In Sweden, bank officers can be required to testify in court, but there is a provision in the Code of Judicial Procedure of 1948 that allows a witness to refrain from giving testimony if this would involve disclosure of a "trade secret," unless there is extraordinary cause.

In Switzerland, the obligation to testify in civil proceedings depends on the law of the canton. Eight of the cantons exempt all persons bound by bank secrecy from the duty to testify. In another eight, bank employees are obliged to testify. In the remaining seven, including Zurich, and probably Lucerne, the court decides in each case whether the bank employee must testify. This compromise solution is followed by the Federal Code of Civil Procedure. There are special protective measures to ensure that secrecy is breached only to the strictest necessary extent.

Attachments

In many countries, litigants can obtain a prejudgment attachment or injunction to prevent removal of assets from the jurisdiction to evade a judgment. Examples of these prejudgment attachments or injunctions include the *Mareva* injunction in English-based countries, the prejudg-

ment attachment in the United States, the *saisie conservatoire* or *saisie-arrêt* in French-based jurisdictions, and the equivalent in other Franco-Latin countries, for example, the Spanish *embargo preventivo*, and the *arrest* in Germanic countries. In order not to alert the defendant, the order is made without the presence of the opponent. Those obtaining an order are responsible for costs if they lose. In addition, court orders are available in all jurisdictions to attach a debtor's assets once judgment is returned in the adversary's favor.

In the case of both prejudgment and postjudgment attachments, a common procedure is that a third-party debtor, such as a bank, owing money to the judgment debtor must disclose details of the amount that the third-party debtor owes when he or she receives the court order of attachment.

In England, a bank receiving a *Mareva* injunction (and probably even if it has merely heard of it) is in contempt of court if it allows a money transfer in breach of the order. Plaintiffs are responsible for the bank's costs and can ask banks to make searches in all of their branches on payment of the bank's costs. However, the bank does not disclose to the plaintiff whether or not it has an account; rather, the bank merely freezes it. It is for the court to order the defendant to make discovery.

English guidelines for the bank's duty on receiving a court sequestration order against a customer were laid down in *Eckman v. Midland Bank Ltd.*[268] In the Irish case of *Larkins v. National Union of Mine Workers*,[269] sequestrators had been appointed by an English court to enforce a contempt of court fine against a labor union. The union claimed that officials of the union had, in defiance of the English court, endeavored to transfer funds out of England into Ireland to escape the English court fine and thereby placed the union's funds in jeopardy. The court ordered the union and the Irish bank allegedly holding the funds not to deal with the funds or dispose of them. Irish banks within the jurisdiction were ordered to produce bank accounts of the union with Irish financial institutions. The injunction was in effect a *Mareva* injunction to prevent removal of the funds from the Irish jurisdiction until the judgment determined the owner of the funds.

In Belgium, a bank must disclose account details in response to a *saisie-arrêt conservatoire* or a *saisie-arrêt exécution.* In France, the effect of legislation introduced in 1991[270] seems to be that the public prosecutor can, at the request of a court bailiff, ask banks where accounts are held. Once an attachment is served, the bank is obliged to declare the balance of the debtor's account as at the date of the attachment. In Germany, Paragraph 840 of the Code of Civil Procedure grants an execution creditor the right to demand information from a third-party debtor (garnishee) of the

judgment debtor and the garnishee must provide the information. This provision applies to banks and overrides banking secrecy.

Greece is exceptional. Notwithstanding the general rule in the Code of Civil Procedure that, in the case of interim or compulsory attachment of a debtor's funds, the third party allegedly owing money to the debtor must notify the court whether he owes money to the debtor or not. It was held that the 1971 secrecy law prohibits Greek banks from making this declaration to the court.[271] This holding only applies to money deposits and not to shares, debentures, or other negotiable instruments deposited with a bank.[272] The same applies to deposits held by foreign banks in Greece.[273] The court said that the object of the secrecy legislation was to increase money deposits with banks so that savings available to finance the national economy could be increased. A 1992 law, however, introduced a limited lifting of banking secrecy in relation to deposits and a right of attachment in case of tax evasion.[274]

The Netherlands follows the usual practice by requiring that banks receiving an attachment order must state what assets of the customer are deposited with it and the deposits that the bank owes to the customer. In Sweden, banks must give information to enforcement authorities in order to enable them to ascertain whether a particular debtor's assets can be attached.

Tracing Assets

Tracing is the right of a person who has been wrongfully dispossessed of an asset either by fraud or some lesser wrong (such as money taken in conflict of interest or money paid by mistake) to follow the asset and its proceeds through its various transformations. The holder of the money, which may be the benefit of a bank account, is known in common law countries as a constructive trustee. This trustee holds the money for the true owner in spite of his own insolvency. Most civil law countries do not follow this principle. In these countries, the proprietary claim of the true owner does not survive the holder's bankruptcy, and the true owner can only claim as an unsecured creditor. In these situations, banks are not a party to the litigation, because, typically, the real wrongdoers have not been identified or have disappeared.

Notwithstanding the general principle that third parties should not be subjected to discovery orders, it has been held in England that discovery can be ordered when the third party has become involved in some way and where this is the only method of discovering the wrongdoer.[275] The court, therefore, can order a bank to disclose the account of a customer to help the true owner trace his money. The jurisdiction is exercised cau-

tiously. In *Bankers Trust Co. v. Shapira*,[276] a bank in New York debited a Saudi customer's account against a forged order and credited the amount to a London bank as instructed by the forgers. The U.S. bank had to restore the money to the Saudi account. The court decided that the U.S. bank should be permitted to inspect correspondence between "the rogues" and the Swiss bank that was held by the London bank. The U.S. bank could only use the information to trace the funds.[277]

In England, the police may also apply for orders to detain bank accounts comprising the proceeds of a crime if the amount concerned can be clearly identified.[278] In *Mohammed Omar v. Omar*,[279] the question was whether information provided by a bank pursuant to a court order granted in relation to a tracing claim could be used for another purpose. This purpose was the pursuit of additional personal claims against the defendants in other jurisdictions, because the evidence apparently produced evidence of other claims. The court allowed the use of the information for other claims.

International Civil Litigation

The taking of evidence abroad is considered by most countries to be in excess of sovereignty and requires the permission of the receiving country. In the nineteenth century and before, foreign protests were aroused by the habit of the English courts of appointing examiners to examine witnesses in foreign countries. In 1895, a prominent English barrister was arrested and imprisoned in Germany for taking evidence from a witness in Wiesbaden. The German authorities considered this action a contempt of court. The Australian courts too have held that the taking of evidence internally, other than through the proper channels, can be a contempt of court.[280] Multilateral cooperation is achieved by international multilateral conventions involving letters of request,[281] bilateral conventions,[282] examination under the supervision of the requesting country's consular authorities,[283] and national rules whereby the national courts will provide assistance in an appropriate case, even without a treaty, in the interests of international comity.[284] Moreover, English courts have allowed videoconference evidence of a witness in New York.

Country Examples

In England, the courts will provide assistance in civil and commercial matters in a manner that is wider than the 1970 Hague Convention,[285] but direct foreign revenue and penal claims are excluded.[286] The provisions of the Evidence (Proceedings in Other Jurisdictions) Act, 1975, also apply to foreign criminal proceedings, subject to limitations. The evidence

requested must not be wider than that available in the country of origin or in the United Kingdom. Fishing expeditions are not permitted and orders are discretionary. The Act is locally enacted in numerous British dependent territories. There is similar legislation in Australia with uniform state laws. The English approach discourages fishing expeditions.[287]

The following cases demonstrate that English courts are reluctant to infringe upon the bank secrecy of banks abroad. In *MacKinnon v. Donaldson Lufkin and Jenrette Securities Corp.*,[288] the court refused a discovery order against the London branch of a U.S. bank in relation to accounts at its New York head office in a civil action alleging international fraud. In *Re ABC Ltd.*,[289] the Cayman Islands court refused to allow a Cayman Islands bank to disclose information ordered by a U.S. court even though the customer had signed a consent. The court said that the consent was signed by order of the U.S. court so, in substance, it was not a free consent but a direction of a foreign court. The decision was affected by the Cayman Islands Confidential Relations (Preservation) Law of 1976.

In *El Jawhary v. BCCI SA*,[290] customers of a bank in liquidation obtained injunctions restraining the liquidator from disclosing information by claiming that disclosure would be in breach of the bankers' duty of secrecy. The bank was part of a larger group being wound up in several countries amid allegations of fraud. The customers were fearful that the information would be leaked to other jurisdictions. The injunctions were granted. The liquidators applied for a variation of the injunction, stating that the liquidator should be able to disclose where the interests of the bank required disclosure, as would be the case with one of the exceptions to *Tournier*.[291] The court held that the variation should be granted. However, in using this exception to *Tournier*, the liquidators should err on the side of caution, especially in disclosing information to insolvency administrators in other jurisdictions. The court would not determine what disclosures could be made in this action. If the liquidators did disclose, there was no obligation to inform the customers.

In the Irish case of *Chemical Bank v. Peter McCormack*, Chemical Bank alleged a fraud of about $800,000 and alleged that the money had been transferred by the defendant to his personal account with the New York branch of an Irish bank.[292] Chemical Bank applied for an order in Ireland declaring that the Irish bank should disclose account entries at its New York branch. The Irish court stated that it did not have power to order inspection in a foreign country, and hence inspection at the New York branch was in excess of jurisdiction. Disclosure of the U.S. accounts, however, was necessary and relevant as evidence. A request, therefore, could be issued to the appropriate U.S. court to assist the Irish court in

obtaining the required information. Chemical Bank was permitted to apply to the U.S. court.

Many countries in the British Commonwealth have similar attitudes, stemming from imperial legislation providing for comity in judicial letters of request addressed to the appropriate authorities in foreign countries. In Argentina, cooperation occurs under Article 132 of the National Procedural Civil and Commercial Code.

In Canada, where statutes are either federal or provincial,[293] pretrial discovery is allowed, and it may be permitted pursuant to foreign letters of request. In *Frischke v. Royal Bank of Canada*, the Ontario Court of Appeal refused to compel the Royal Bank of Canada to disclose information by obtaining the information from their Panama branch, contrary to Panamanian secrecy laws.[294] In *Compalex Resources International v. Schaffhauser Kantonalbank*, an Ontario court compelled a representative of a Swiss bank to produce documents and answer questions concerning the bank's customers in a civil action in Ontario, even though this was confidential information under Swiss law. Disclosing this information subjected the bank and its representatives to criminal and civil sanctions under Swiss law.[295] There were complex subsequent proceedings in this case.

In France, Sections 733–748 of the new Code of Civil Procedure require reciprocity. In Japan, the Law Relating to the Reciprocal Judicial Aid To Be Given at the Request of Foreign Courts [296] requires reciprocity and covers both civil and criminal cases. In the United States, the procedure is governed by federal or state procedural statutes and the 1970 Hague Convention. Apart from the Convention, the main federal rule is discretionary.[297]

Multilateral Conventions

There are three main Hague Conventions on civil procedure—1905, 1954, and 1970.[298] Both the 1954 and 1970 Conventions replaced the letter-of-request procedure of the earlier Convention, but the earlier Convention may still be in force between the various contracting parties. A country may have accepted obligations under the 1954 Convention to one group of countries, as well as obligations under the 1970 Convention toward another group of countries.

The Hague Convention of 1970 and the Inter-American Convention of 1975 [299] contain exclusions that permit contracting countries to refuse evidence or discovery that contravenes local secrecy. The Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, 1970, provides that a judicial authority may request a competent authority in another contracting country, by means of a letter of request, to obtain evidence, including discovery of documents. Under Article 1, the request may only be used for evidence intended for judicial proceedings, commenced or

contemplated. The executing authority applies its own procedures, under Article 9. Article 11 allows the person concerned to refuse to give evidence if, among other things, he can refuse under the law of the country of execution or origin. Under Article 12, execution may be refused if the country addressed considers that its sovereignty or security would be prejudiced thereby. Contracting countries can exclude pretrial discovery of documents under Article 23. Most of the signatories have done so, including the United Kingdom but excluding the United States.[300]

Switzerland is a signatory to the 1905 Hague Convention, as amended in 1954. In practice, national law takes precedence over the provisions of the Convention. Therefore, in Switzerland the success of a mutual assistance application under the Convention will depend upon the applicable cantonal law. A negative response would arise if the banker must testify in Geneva, while the same bank could be compelled to testify in Basle. Switzerland also has a number of bilateral treaties and may render mutual assistance on the basis of reciprocity in the absence of a treaty, provided there are no compulsory measures.

The Inter-American Convention on Letters Rogatory of 1975 (with Protocol of 1979) provides for certain formal procedural acts and for the taking of evidence abroad, subject to reservations, by letters rogatory in connection with proceedings in civil and commercial matters.[301] It does not apply to acts involving measures of compulsion.[302] Execution is in accordance with the law of the country of destination[303] and must not be contrary to local public policy.[304]

Arbitration

In some cases, the court may send or receive requests for evidence at the request of an arbitral tribunal in civil and commercial matters, for example, in England and related countries. The jurisdiction is often unclear, but in any event the intrusion on bank secrecy will never be greater than that available in court proceedings.

In Switzerland, arbitrators are not entitled to compel testimony. Article 184 of the Statute on Private International Law, however, provides that the courts may order access, including to bank information, at the request of the arbitral tribunal.

Disclosure in Insolvency Proceedings

Domestic Insolvency Proceedings

Insolvency may cause a breach of bank secrecy in two main situations. Either the bank itself is insolvent, or the insolvent has a bank account. In

both situations, the insolvency administrator requires information in order to enable him, for example, to ascertain and collect the assets or determine any wrongdoing and report it to the authorities. This determination of wrongdoing pertains to any action for which directors must bear personal liability. Wrongful or fraudulent trading, such as incurring credit when the company is insolvent, provides an example of a situation in which a director would face personal liability. This determination of wrongdoing should also ascertain if there have been any preferences (payments or transfers that should be avoided and the property restored). Although an insolvency administrator is the successor to the business, his position leads to greater disclosure because of the reports to creditors and authorities.

In the case of bank insolvencies, a special legal regime may apply in order to safeguard depositors and the banking system. This is the case in the United States. More commonly, the ordinary corporate insolvency rules apply, with enlarged powers being granted to the banking authorities who may, for example, be entitled to initiate themselves an insolvency proceeding, as in Britain. The extent to which banking supervisors can, in the case of insolvency proceedings involving a bank, continue to use their enhanced powers to command information is a matter for detailed investigation.

As to ordinary corporations, in Britain, Section 236 of the Insolvency Act, 1986, provides that the court can order production of information in relation to a company in an insolvency proceeding. The court may, on the application of the insolvency representative, summon to appear any person "whom the court thinks capable of giving information concerning the business, dealings, affairs or property of the company."[305] This standard provides considerable discretion. The procedure is inquisitorial. Accordingly, the courts will guard against oppressive investigative orders. The insolvency administrator is, of course, allowed access to the insolvent's bank account information, but the courts are reluctant to compel disclosure of third-party accounts.[306]

Canadian bankruptcy legislation has similar provisions for disclosure in favor of an insolvency administrator. In *Royal Bank v. Oliver*,[307] a bank creditor of two insolvents was successful in obtaining a court order permitting the questioning of the bankrupts' wives and requiring the production of banking and investment records of other financial institutions.

Canadian cases have also developed the disclosure rules where the bank is itself insolvent. In *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*,[308] the bank was in liquidation and the Canadian Deposit Insurance Corporation (CDIC) paid out more than $1 billion to depositors. The CDIC took legal action against former officers of the

bank and required documents in the possession of the liquidator on the grounds of the public interest. The court held that, on the basis of *Tournier*, the CDIC was entitled to the information on the grounds of an overriding public interest. In *Surrey Credit Union v. Willson*,[309] there was an application to have information in the hands of a liquidator of a failed bank disclosed in civil proceedings against the bank directors and others. The court allowed the production of the documents in view of provincial subpoena laws and rules of court.

In France, insolvency proceedings are largely court driven. A 1984 law[310] gives the President of the Court the power to obtain information from banking institutions that is necessary to assess the debtor's situation. Under the Bankruptcy Law of 1985,[311] the insolvency administrator can obtain information for the purposes of drawing up a rehabilitation plan, and bank secrecy cannot be invoked against the insolvency representative who acts as a legal representative of the bank's customer. By virtue of Article 184 of the Bankruptcy Law of January 25, 1985,[312] when sanctions are imposed against directors of a corporate body subject to insolvency proceedings, the court can lift bank secrecy to assess the totality of the directors' wealth. Director liability for the debts of the company is a serious risk in France.

In Greece, bankruptcy trustees can access the bankrupt's account.[313] In Luxembourg, Article 485 of the Commercial Code allows the judge-commissioner to compel the bankrupt or any other persons to verify balance sheets and to investigate the reasons and circumstances of the bankruptcy. Bank secrecy is overridden as regards the bankrupt.

In Switzerland, the trustee in bankruptcy is entitled to full disclosure of account information pertaining to the bankrupt's client accounts. This principle also applies in the bankruptcy of a bank. Creditors, through the insolvency representative, may have wide access to client-related information if necessary to protect their interests, subject to special safeguards in the Federal Law on Banks and Savings Banks of 1934.[314]

International Insolvencies

As for international bankruptcies, most legally developed countries require the insolvency administrator to collect the global assets. Therefore, global discovery is required. Also, discovery is required if there is suspected wrongdoing.

Insolvency recognition is a large subject. Discovery is also not a minor subject. The international trend is to recognize the insolvency proceedings of the main forum, sometimes automatically (for most English-based countries), sometime by way of a recognition order (the Franco-Latin

exequatur), sometimes by way of treaty, and sometimes by way of special rules for ancillary proceedings.[315]

Recognition usually covers the freeze on enforcement actions and the right to collect the assets. It is not generally a recognition of the insolvency laws of the home country as a whole. Discovery is available in the United States through Section 304 proceedings,[316] but the English approach is more restrictive.[317] Conversely, the English courts do not treat their own wide discovery powers in Section 236 of the Insolvency Act, 1986, as having extraterritorial effect.[318]

In Switzerland, if there is a Swiss ancillary liquidation under the Private International Law Statute of 1987, only the Swiss insolvency representative has the right to obtain information from the bank. If there is no international treaty and no ancillary bankruptcy proceeding in Switzerland, the better view is that a foreign bankruptcy receiver is entitled to lift bank secrecy on the ground that he is the representative of the corporation. If this were not the case, then nobody could represent the corporation in liquidation. There is a bilateral bankruptcy treaty between France and Switzerland of 1869 that, according to the Swiss Federal Court, obliges Swiss banks to give information to the French trustee in bankruptcy.

The alternative is for the liquidator to arrange for a creditor to commence a full bankruptcy proceeding in the foreign jurisdiction in order to attract the foreign bankruptcy discovery rules.

Miscellaneous Examples of Disclosure

Exchange Controls and Trade Laws

The diminishing number of countries that have exchange controls habitually call banks to police the rules. It is thought that international mutual assistance in exchange control enforcement leading to a piercing of foreign bank secrecy is negligible. Article VIII, Section 2(b) of the International Monetary Fund's Articles of Agreement attempted to secure a degree of international recognition by the courts of IMF members concerning the exchange controls of an IMF member that are maintained or imposed consistently with the Fund's Articles.

Customs and trade laws that, for example, prohibit imports or impose tariffs have also received little international cooperation in the field.

Antitrust Laws

Antitrust legislation seeks to encourage competition by controlling monopolies and restrictive practices, such as price fixing. The legislation

commonly allows the authorities to override bank secrecy in connection with antitrust investigations. An example is Section 155 of the Australian Trade Practices Act (Commonwealth), 1974. International mutual assistance is highly controversial and, as mentioned, has been the subject of numerous blocking statutes.

Embargoes and Freezes

Typically, freezes under "trading-with-the-enemy" legislation involve a piercing of bank secrecy. International cooperation generally requires the consent of countries. This consent can be established either by treaty or harmonizing statute.

Public Registration Systems for Security Interests

Public registration systems for security interests lead to a lifting of bank secrecy in relation to secured transactions appearing on the register. Examples are land, ship, and aircraft registers, the filing system for personal property security interests in the United States [319] and some Canadian provinces,[320] and the corresponding system of registration of corporate charges at the Companies Registry in most English-based systems. Public registration of security interests over personal property is not widely adopted in Austria, Germany, the Netherlands, and Switzerland. In Franco-Latin countries, nonpossessory security over personal property is very limited in any event. Generally, the creditor must have a possessory pledge, but there are many exceptions.

Bank Mergers

Bank mergers lead to disclosure. This usually follows without difficulty if there is a universal succession to assets and liabilities of a business. Express confidentiality contracts may cause problems. The question does not arise if the merger is by an acquisition of the shares of a bank, as opposed to a fusion.

Heirs

When a customer dies, the probate courts or administrators will require information to ascertain the deceased's assets. There may be limitations on the rights of creditors and beneficiaries to information in some jurisdictions, especially information about the deceased's past bank transactions. The heirs are interested in present assets, not past dealings, which, it is thought, should be allowed to accompany the deceased to the grave. In Switzerland, heirs, but not legatees, are entitled to information as suc-

cessors, except for "highly personal rights" that usually will not include bank information. Swiss banks, on the other hand, tend only to disclose information regarding the country of the assets at the time of the death. In Greece, heirs are entitled to lift bank secrecy because they are successors, although this is not necessarily so in relation to joint accounts in which a deceased was a holder. Luxembourg appears to have a similar view to Switzerland. Heirs are entitled to information about the assets of the deceased. The deceased has a right to protection of his private life. Consequently, his heirs cannot obtain information relating to transactions made by the deceased before his death.

Spouses

Husband and wife may have disclosure rights in respect of each other's bank dealings, particularly in countries adopting community of matrimonial property. This may be no more than a reflection of the rights of joint-account holders. In France, a surviving spouse can override the banking secrecy owed to the other spouse in order to liquidate the community. In Switzerland, spouses agreeing to a joint-property regime have equal rights to bank information, but otherwise each spouse has individual bank secrecy.

Apart from this and apart from joint accounts, banks must observe bank secrecy toward each spouse separately in Denmark, England, France, Greece, Norway, and Sweden. There may be special court discovery powers in relation to divorces so as to enable the unhappy spouses to verify the financial situation of each other. In France, in the case of divorce, a judge can carry out all the necessary inquiries in relation to financial provision for spouses without their being able to invoke secrecy.[321]

Joint Accounts

A single joint-account holder can usually release the bank from a secrecy obligation toward third parties so as to override the other joint-account holder. Sometimes a bank can be authorized to release only information relating to the joint-account holder concerned, but the matter should be investigated in detail. In Switzerland, joint-account holders are entitled to comprehensive information on the joint account.

Partnerships and Companies

Generally, partners have a separate right to banking information because they all have unlimited liability and (often) duties of the utmost disclosure to each other. This is probably true of shareholders in various

forms of private companies who are personally liable to third parties. French courts have upheld this proposition. However, shareholders are not entitled to direct information about the corporate bank account as a universal proposition. Shareholders must obtain information from the company, and their right to information is governed by company law.[322]

Miscellaneous

Other examples of disclosure in Britain are contained in legislation relating to consumer protection, mental incapacity, regulation and disciplining of solicitors, and investigation of charities. Greece has an unusual provision for lifting bank secrecy in relation to the financial resources of politicians, the directors of public sector corporations, media editors and managers, the shareholders of 5 percent of any Greek bank and holders of 10 percent of media companies and their relatives.[323]

COMMENT

LEE J. ROSS, JR.

All over the world, a growth in international criminal activity has occurred. The criminal groups involved respect no national borders or boundaries; they move their money, power, and corruption from place to place, depending on where they perceive the greatest rewards lie or where the weakest deterrents in the economic or law enforcement systems exist. One of the principal goals of these groups is to legitimize and return their illicit proceeds to the world's financial system—in other words, to launder their criminal gains. To achieve this objective, the groups have often sought to conceal their activities through the protection afforded by the doctrines of banking secrecy. This tactic, in turn, has necessitated responses from the responsible supervisory agencies and the law enforcement authorities that result in departures from these doctrines.

The world's international organizations have recognized this international money-laundering threat and, on many levels, have come together to try to formulate financial, regulatory, and legal norms of behavior to combat international organized crime. These include the Financial Action Task Force (FATF), with its 40 recommendations on money laundering;[1] the Organization of American States (OAS), which has adopted model regulations on money laundering;[2] and the Caribbean Financial Action Task Force, which has devised principles for Caribbean nations as well as certain participating Central and South American nations.[3] In addition, a *Statement of Principles Concerning Prevention of Criminal Use of the Banking System for the Purpose of Money-Laundering* exists.[4] It was prepared in 1988 by the Basle Committee on Banking Supervision with respect to money laundering and the safety and soundness of the international banking community. Other international anti-money-laundering documents include the 1988 Vienna Convention,[5] the ancestor of all anti-money-laundering documents; the EC Directive of 1991;[6] and the Council of Europe's Convention of 1990.[7] Recently, in December 1995, 29 nations signed the Summit of the Americas communiqué in Buenos Aires, which elaborated certain minimum principles for all countries in Central and South America to adopt as a threshold for combating international money laundering.[8]

Why is money laundering a key target of law enforcement? Governments try to enlist their financial sectors in law enforcement efforts to target and eliminate international organized criminal activity inasmuch as most organized criminal activity is undertaken expressly to

make a profit. Organized crime operates for profit organizations, not charitable organizations. While criminals may make local contributions to their political parties of choice and even, on occasion, for local charitable purposes, these contributions occur largely because of the criminals' desire to corrode and corrupt public institutions, not because of altruistic motives. Therefore, attacking the financial side of this organized criminal activity is crucial.

Money laundering permits law enforcement to pursue criminal activity in two directions. First, following the money "downstream" permits an attack on the professional laundering organizations that have sprung up to cater to the needs of organized crime. These laundering organizations are composed of people who may go to church, who contribute to civic associations and political parties, who are bankers, lawyers, money exchangers, accountants, insurance sellers, real estate agents, automobile dealers, stockbrokers, and many others. Organized crime purchases every form of financial assistance possible. It will find the weak link in the system. Thus, organized crime activity cannot survive without the use of such professionals, and law enforcement must necessarily look to the financial infrastructure professionals—central bankers, commercial bankers, as well as nonbank financial professionals—for assistance in identifying, targeting, and eradicating the use of the world's financial systems by criminals. Bankers and other professionals involved in the legitimate international financial systems are crucial in any effort to find, detect, investigate, and prosecute those who abuse the world's financial systems. Attacking downstream money laundering consists of attacking the professionals who assist in laundering and cleaning up the dirty money.

Second, attacking money laundering leads to "upstream" results as well, especially with respect to those criminal enterprises that commit the underlying predicate crimes generating the proceeds to be laundered. Once the money launderers are identified, a link exists that enables one to identify the cartels involved in the narco-trafficking, prostitution, smuggling of aliens, and other forms of organized crime activity.

However, a tension involving bank secrecy exists because the legitimate expectation of financial privacy possessed by an individual or company in financial dealings must be balanced against the legitimate interests of a country that relies on its law enforcement apparatus, domestically and internationally, to detect, investigate, and prosecute the abuse of the financial system by criminals.

Each country's approach to addressing this tension is likely to differ, depending on constitutional, common law, and statutory constructs. In the United States, for instance, the Supreme Court has held that no constitutionally protected privacy interest in one's financial dealings at a bank

exists.[9] When the Bank Secrecy Act was passed in 1970,[10] the banks attacked the constitutionality of requirements that force them to file large-value reporting forms with the government. The Supreme Court ruled that financial institutions do have to file such forms,[11] and that there was no constitutional right to privacy in one's bank records.[12] Congress stepped forward and passed the Right to Financial Privacy Act, which, statutorily, prescribed the circumstances in which the government could access such financial information for the purposes of legitimate law enforcement activity.[13]

Different countries clearly have different approaches to the regulation of their financial systems. As was pointed out in Chapter 17, while some form of bank secrecy is the rule, for purposes of anti-money-laundering enforcement, the key is under what circumstances that rule may or must be pierced. The United States has adopted and implemented a multipronged approach to combat both domestic and international money laundering, including both mandated large-value[14] and suspicious-transaction reporting,[15] record keeping for such activity as wire transfers exceeding $3,000,[16] criminal statutes penalizing the laundering of the proceeds of many domestic and international predicate crimes (the latter including fraud against foreign banks), as well as a statute providing for the forfeiture of both the proceeds and the instrumentalities of crime.[17] Whether every country needs all aspects of this regime is uncertain; however, every country needs some of its components. Nevertheless, to put financial reporting into place by both bank and nonbank financial sectors (money exchangers, stockbrokers, and the like), bank secrecy laws must be pierced in certain circumstances.

Every country likely has a specific problem with respect to money laundering that is unique to that country. The people most likely to know how to approach the laundering of criminal proceeds in any given country's financial system are the people who are engaged in that system—the bankers and other financial specialists who are intimately familiar with the strengths and weaknesses of the country's financial system. As previously noted, cooperation between a country's financial specialists and domestic and international law enforcement officials must occur to increase the likelihood of catching money launderers.

In the United States, the approach was not initially based on cooperation. The Bank Secrecy Act mandated a large-value reporting regime for banks[18] and thereby revealed the tension between law enforcement and banking interests. In a mandated large-value reporting regime, if someone deposits, withdraws, or transfers cash in excess of a predetermined amount (in the United States, amounts exceeding $10,000),[19] the designated financial entity must file a report and identify certain information about the transaction.

Engaging in the large-value transaction itself, unless other indicia of criminal activity apply, does not mean that a person is guilty of a crime. Thus, if someone brings in or takes out more than $10,000 when he or she enters or leaves the United States, that person is required to complete a special form and submit it to the U.S. Customs Service prior to entry or departure.[20] This requirement does not impede the movement of currency into the country or out of it. It is merely a signal to the Treasury Department that someone brought the currency into or took it out of the United States.

Mandated large-value reporting targeting the placement of drug proceeds into the U.S. financial system was the basic approach that the United States took in 1970. The rationale behind this system was that the United States has a huge financial infrastructure and officials had reason to believe that criminals were depositing drug proceeds directly into that system with impunity. The government, however, first had to identify where the money was being deposited and then work to separate the clean from the dirty. Where cash placement of criminal proceeds is a country's most glaring problem, mandated large-value reporting will flush it out of hiding and force it into other, unfamiliar channels where the government may be able to more easily identify and target it.

What about countries with a much smaller financial infrastructure? What if, for example, instead of 10,000 banks, a country has only 50 major banks. With only 50 major banks, is mandated large-value reporting really necessary? It depends upon the nature of the money laundering that is occurring. If the physical deposit or physical transportation of drug proceeds directly into or out of a country's financial system is the problem, then some form of mandated large-value reporting by those institutions infected by such criminal proceeds is a necessity. It is a necessity because regulators will identify who is depositing that cash into what parts of the financial system. This was the first approach taken in the United States.

Twenty-five years, and millions of filed forms later, the United States is looking for a way to maintain mandated large-value reporting, but to balance that reporting against the burdens on the financial system. Also, in the 25 years the United States has gone from a system of confrontation to one of cooperation with its financial systems. The United States has succeeded in forcing cash placement money launderers to look elsewhere to place larger percentages of their cash, whether through physical transportation, concealment in cargo, or downstream introduction by feeder nonbank financial institutions.

Having achieved this goal, the United States is now looking to increase the exemptions banks can give to specified customers for whom no man-

dated filings need be made to the Treasury Department. In April 1996, the Treasury Department's central financial database group, the Financial Crimes Enforcement Network (FinCEN), published new regulations permitting banks to exempt large categories of customers from mandated filings.[21] At the same time, however, the United States is moving into a mandated suspicious-transaction reporting regime. In February 1996, the Treasury Department issued regulations that mandate suspicious-transaction reporting by banks.[22] If a transaction is unusual or suspicious, regardless of its amount, then the bank must file a report with the Treasury Department.[23] Thus, the United States is keeping the most essential aspects of large-value reporting, while expanding the exemptions from that reporting, but is also moving toward a mandated suspicious-transaction reporting regime.

A country, therefore, has the option of implementing a reporting system for large-value or suspicious transactions, or both, on a voluntary or mandatory basis. The mix selected by any country will be determined by its own internal analysis of the money laundering occurring in its financial system. Arguably, the reporting, to be effective, must be mandatory and must cover all serious criminal activities, not just drug trafficking.

This comment has focused on only one side of the law enforcement/banking tension up to this point, that is, what countries should require their financial systems to report to counter money-laundering activity. What about the other side of the equation? What about bank secrecy issues? In the United States, Congress enacted a statute that insulates financial institutions that report to the government in good faith from any civil liability to a private party.[24] If such reporting is to be mandated, a "hold harmless" provision must exist to insulate from civil liability any bank that files a report in good faith. Otherwise, the institution will be caught between two dilemmas: a possible charge of money laundering or civil litigation brought by the account holder. A hold harmless provision in favor of a reporting financial institution is a necessary correlative to mandatory suspicious-transaction reporting.

How should reporting be handled? To whom should the reports be sent? The particular regime by which suspicious reports are given and handled within a particular government differ. In the United States, the central data unit, FinCEN, was created within the Treasury Department. It receives directly all such suspicious-transaction reports. Other countries have buffers between the police, the entity that initially receives the report, and the reporting banks and nonbanks. A country's reporting regime could contemplate disclosure directly to the police, the Ministry of Justice or Ministry of Finance, or to a buffer in between, for example, the central bank.

In addition to legislating these actions that pierce bank secrecy laws, the United States has money-laundering statutes that criminalize intentional use of the financial infrastructure to launder the proceeds of a myriad of domestic and international predicate crimes.[25] These statutes criminalize the initial placement of illicit proceeds into the U.S. system, the layering of those proceeds through wire transfers and other transactions, and the final integration of the proceeds back into the legitimate sector through the purchase of goods.

The final components of the U.S. anti-money-laundering regime are the asset forfeiture laws.[26] Once a corpus of illicit proceeds is identified, they can be frozen and ultimately forfeited either in a civil or criminal setting. Asset forfeiture of laundered proceeds and instrumentalities is a crucial part of any anti-money-laundering enforcement regime because it takes the proceeds out of the criminal's pocket. The criminal statute, puts the launderers into jail. The forfeiture law decreases the launderers' rewards after jail. Prior to asset forfeiture laws, the criminal would say, "Well, I'll tell you what, you've got me, I'm going to go to jail for five years, but when I come out, I'll be just fine." Those days are over in the United States.

Thus far, this comment has been concerned with the reporting and record keeping requirements that the U.S. government has imposed on the financial industry through legislation or regulation. What can industry do in the ongoing struggle to purge itself of illicit proceeds laundered through it? The most significant way for financial institutions to shield themselves from unintentional collusion in money-laundering activity is to know their customers. This requirement does not end upon accepting bona fides at the time of opening an account, but also requires knowledge of changes in legal and beneficial ownership, as well as an awareness of what the customer does.

Both government and the regulated financial institutions must work together, not only to identify potential money laundering, but to draft strategy as well. In the United States, a more collegial relationship currently exists between the government and the banking sector than had existed in the past. The banking community acknowledges this partnership. It is not an agent of the government, but is in partnership to pursue a joint strategic goal to purge the U.S. financial system of as much criminal proceeds as possible.

Reflecting this collegial approach, the Bank Secrecy Act Advisory Group, chaired by the Department of the Treasury, was established. The group, composed of a mix of governmental (law enforcement/regulators) and nongovernmental (banking industry members, as well as check cashers and wire transferers) representatives, is small but influential. At its

meetings, current issues in money laundering are discussed. The government representatives may note that they are thinking about the possibility of amending a statute or asking for additional regulatory authority. They may ask the banking regulators what they think of this proposal, does it make sense, or is there another way it could be done to produce less impact on the banks, but at the same time provide the government with the needed information. Other issues, such as the possible use of evolving technologies (smart cards and the like) for money laundering may also be discussed. The group has assisted the government in tailoring other regulations and preventing the promulgation of regulations that would not produce their desired effect. The establishment of such groups in other countries should be encouraged.

As noted above, the money-laundering problem in each country is different. Some countries have placement problems with cash. In some Caribbean islands, the chief problem in money-laundering concerns wire transfers. In other countries, financial institutions are not even used for the primary or the secondary stages of laundering, but are used only at the final stage of money laundering. The final stage of laundering, the integration of the proceeds of criminal activity back into the legitimate community, is the hardest stage at which to detect the illegal proceeds.

Below follows a very brief survey of the international efforts to fight money laundering and the U.S. participation in them. The United States is a member of the Financial Action Task Force, serving as its President in 1996. The United States participates in the Caribbean Financial Action Task Force, as well as the OAS's Inter-American Drug Abuse Control Commission, which has drafted model money-laundering regulations.[27] In 1995, the United States participated in drafting the Summit of the Americas communiqué, which recommended that anti-money-laundering measures be undertaken and implemented throughout the western hemisphere.[28]

Bilaterally, the United States has 19 Mutual Legal Assistance Treaties with foreign countries in force. Money laundering is one of the areas in which the United States can both request and give assistance under a treaty, where appropriate.[29] Similarly, the United States has entered into a number of tax information exchange agreements, financial information exchange agreements (with respect to the exchange of currency information on deposits and withdrawals), and customs agreements, where financial records may be shared to assist in investigations of money laundering and other financial crimes.[30]

To summarize, the tension between legitimate expectations of privacy in financial dealings and the need of any country to purge itself of criminal proceeds must be recognized. The government's need is very impor-

tant for the protection of a country's financial integrity and reputation, as well as from preventing potentially corrupting and destabilizing effects. Laundered money leaves telltale signs that clean money does not. Strong know-your-customer policies, strong reporting (particularly suspicious-transaction reporting to a centralized financial database), and cooperation between government regulators and financial institutions can help to combat the international money-laundering problem while preserving the core principles that underpin bank secrecy.

Chapter 18

Financial Services in the General Agreement on Trade in Services: Framework and the 1995 Negotiations

MASAMICHI KONO AND PATRICK LOW[1]

Introduction

The financial services sector—defined in the context of the General Agreement on Trade in Services (GATS)[2] as encompassing all banking and other financial services, and all insurance and insurance-related services[3]—is one of the largest and most significant sectors taken up for negotiation since trade in services became an integral part of the multilateral trading system. The European Commission has estimated that international financial services comprise some $40 trillion in terms of banking assets and deposits, $10 trillion in stock market capitalization, $10 trillion in the market value of bonds, and $2 trillion in insurance premiums.[4] This vast industry is significant not only for its size, but also since financial services are a basic input in virtually every other economic activity, whether in the field of goods or services.

More and more governments recognize that the inability of traders and investors to enjoy ready access to a competitive and efficient supply of these services represents a severe obstacle to growth and development. This realization is reflected in an increasing deregulation and liberalization of the sector. Although in many ways only a first step, the multilateral negotiations on financial services that took place in the Uruguay Round are indicative of this market-opening trend.[5] The internationalization of financial services has grown rapidly over the past two or three decades. This is not only a reflection of liberalizing tendencies in many countries. New technologies (especially in telecommunications), the expansion of foreign direct investment, and financial innovation have all played a part.[6]

This chapter addresses the context of the GATS financial services negotiations that resulted in an interim agreement in July 1995 and briefly assesses the results. It starts by explaining the GATS framework within which the negotiations took place. The following section then considers the relationship between commitments to liberalize trade in financial services under GATS and policies relating to prudential regulation and to financial flows on the current and capital accounts of the balance of pay-

ments. The penultimate section traces the outcome of the financial services negotiations in 1995 and examines the interim results, while the last section offers some conclusions.

GATS as a Framework for Negotiations

The GATS consists of a framework of rules and country schedules containing specific market access commitments. The rules are based on many of the concepts originally developed in the context of the General Agreement on Tariffs and Trade (GATT), but significant differences also exist, arising from the fact that the GATT deals with trade in goods and the GATS with trade in services. Two particular features of service activities that distinguish them from production and trade in goods deserve mention at the outset. First, production and consumption of a service may occur simultaneously, since no possibility exists of storing certain services produced now for consumption later. Hair cutting and shoe shining are obvious examples of this class of service. In the case of many services, including those just mentioned, arm's-length supply is impossible because the service is not transportable. A physical presence is therefore necessary. Thus, either because of the "nonstorability" and/or "nontransportability" of certain categories of services, if a government grants market access rights to foreign suppliers, it may have to accept either that foreign enterprises can establish a commercial presence in its territory or that the service suppliers in question may enter its territory on a temporary basis.

The delivery of many financial (and other) services is not so intrinsically restricted, and arm's-length delivery across frontiers is feasible, although not always desirable from the point of view of the supplier and the consumer. Where repeated transactions are required, such as in retail banking, a continuing local presence may be more desirable than long-distance supply. The quality of a service may also be influenced by the ability of a service supplier to locate in close proximity to consumers. Thus, even where establishment or temporary presence is not essential to an exchange, a preference may exist for the physical presence of the producer in the territory of the consumer or vice versa. On the other hand, modern information technology[7] has greatly increased the scope for arm's-length delivery. The essential point here is that either through force of circumstance or because of the nature of an activity, trade in services cannot be promoted without a willingness on the part of governments to contemplate multiple modes of delivery, involving the movement across national jurisdictions of the services themselves, or of producers or consumers. As mentioned further in this chapter, these realities are reflected in the GATS.

The second important distinguishing feature of services activities is that they tend to be subject to a greater degree of regulatory supervision

than are physical goods. In part, this reflects concerns about consumer protection, or in the case of financial services, prudential issues. Because fraud, sharp practice, and substandard output are often more difficult to detect than in the case of goods, or perhaps even impossible to detect and prevent, before the damage is done, governments feel obliged to control their supply *ex ante* rather than their output on an *ex post* basis. Another consideration is that some service sectors, such as banking, have economy-wide externalities, such that regulation erring on the side of caution is considered necessary to avoid the widespread damage that would be caused by specific sectoral failures.[8] On the other hand, heavy regulation may also reflect nothing more than protectionist policy, where for one reason or another governments are unwilling to countenance foreign competition. Either way, the relative intensity of regulation in many service industries contributes to the complexities of promoting trade liberalization.

Inevitably, the focus of negotiations in trade in services will tend to be upon sectors, although there is undoubtedly room to do more by way of developing principles applicable to all services trade, regardless of the degree of sector-specific liberalization that governments are willing to undertake. Given the greater necessity of regulation from a consumer protection perspective in the sphere of services, progress in trade liberalization should not be judged merely by reference to the pace and degree of deregulation. Conversely, deregulation does not always mean the same as liberalization. The role of regulation loomed large in the Uruguay Round negotiations, and an implicit tension exists between some elements in the GATS general framework and the specifics of scheduled sectoral access commitments.

A final point worth making at the outset concerns the severe dearth of information available to policymakers and analysts about service transactions. For the most part, governments have not collected data on international service transactions in a systematic fashion, save in a highly aggregated and not always internationally comparable form in the balance of payments accounts. As one observer, Richard Cooper, has stated, "we are wallowing in ignorance when it comes to international transactions and services."[9] Attempts are being made by the Organization for Economic Cooperation and Development (OECD), Eurostat, and the International Monetary Fund (IMF) to improve the standard of data collection in services,[10] but these efforts will take several years to bear fruit. Moreover, problems will still arise because of a growing range of intrafirm electronic service transactions that are not recorded in conventional balance of payments statistics. A further limitation of data on services transactions is that so-called establishment trade—the sales of foreign-owned enterprises in the host country—is not recorded under existing statistical

methodologies with the notable exception of the United States.[11] Finally, as another observer, Jagdish Bhagwati, pointed out over ten years ago, services statistics will be influenced by economic structure.[12] For example, where a manufacturing firm maintains in-house advertising services, advertising will be recorded as goods production; however, a manufacturer who buys advertising from an agency triggers a transaction that will be recorded in national output statistics as advertising services. Specialization that leads to outsourcing of service inputs into manufacturing is referred to as "splintering."

Basic Concepts

Part I of the GATS sets out the scope of the agreement, the definition of trade in services, and sectoral coverage. Trade in services is defined in Article I in terms of four modes of supply. The first mode involves the cross-border (arm's-length or long-distance) supply of a service from one jurisdiction to another.[13] This mode of delivery is analogous to international trade in goods, in that a product crosses a frontier. Many different kinds of electronic information flow occur across national borders, and this mode is particularly relevant in many financial service activities. The second mode of supply requires the movement of consumers to the jurisdiction of suppliers.[14] Tourism is a good example of this mode, involving the movement of (mobile) tourists to (immobile) tourist facilities in another country. The third mode of supply is through the commercial presence of a supplier in the jurisdiction of consumers.[15] This is the investment mode, where for one reason or another a service supplier must be, or wishes to be, close to the market being supplied. Finally, the fourth mode entails the movement of natural persons from one jurisdiction to another. The fourth mode relates both to independent service suppliers and to employees of juridical persons supplying services.[16] This mode is particularly relevant to suppliers of professional services. The conceptual approach underlying these modes was first developed in the academic literature[17] as a heuristic device to explain the nature of international transactions in services. Differentiation by modes of supply later formed the basis on which governments defined market access commitments under the GATS, permitting a choice to be made from among alternative modes.

A second feature of the definition of services covered by the GATS is the exclusion of services supplied in the exercise of governmental authority.[18] The definition of a service supplied in the exercise of governmental authority is "any service which is supplied neither on a commercial basis nor in competition with one or more service suppliers."[19] The intention

of this provision is to permit governments to exclude basic infrastructural and social services that they supply their populations on an exclusive basis from the purview of the agreement.

As far as sectoral coverage is concerned, the GATS is intended to cover all services. The only exclusion to what would otherwise be universal sectoral coverage arises in the Annex on Air Transport Services, which excludes traffic rights and services directly related to the exercise of traffic rights.

The GATS, similar to the GATT, is based on the most-favored-nation principle, which requires that members of the GATS accord to "services and service suppliers of any other Member treatment no less favorable than that it accords to like services and service suppliers of any other country."[20] While governments were able to accept practically universal sectoral coverage in the GATS, not all of them were willing to apply the most-favored-nation principle across the board, and so Article II of the GATS permits members to list in an annex most-favored-nation exemptions relating to specified measures.[21] These exemptions could only be taken at the time of entry into force of the GATS and the initial GATS commitments. They cannot be added to in the future; they are subject to review; and, at least in principle, they are supposed to be of limited duration.[22] The most-favored-nation exemption provisions reflected in part the desire of members to preserve existing preferential arrangements that were not broad based enough to be covered by the GATS Article V provision permitting departures from the most-favored-nation principle in the name of economic integration.

The pressure for most-favored-nation exemptions was also a reflection of the concern on the part of some larger countries that, by granting most-favored-nation access to their markets, they would be losing the opportunity to exchange their relatively open access for further liberalization in other markets. In other words, these countries were arguing that "free riding" would occur in the absence of an effective instrument to ensure reciprocity. The issue was raised most explicitly in the telecommunications and financial services negotiations. Some 60 countries took most-favored-nation exemptions, affecting most significantly the audiovisual, financial, basic telecommunications, and transport services sectors. As explained in more detail further in this chapter, the most-favored-nation exemption in the financial services sector was suspended, pending the outcome of the post-Uruguay Round negotiations in this sector.

A fundamental feature of the GATS is the principle of progressive liberalization. It reflects the reality that governments were neither willing nor able simply to open up their services markets to international competition from one day to the next. Progressive liberalization implies a gradual approach, and the structure of the GATS accommodates such gradualism.

The most-favored-nation principle in Article II and the transparency commitments in Article III are the main general obligations of the agreement. In addition, the obligation to establish appropriate judicial, arbitral, and administrative complaint procedures[23] is of a general nature, as are the rules on economic integration,[24] certain provisions dealing with recognition of qualifications,[25] monopolies and exclusive suppliers,[26] and business practices.[27] Other provisions contained in the GATS apply to, or are only relevant to, sectors where specific commitments are undertaken by members in their schedules of specific commitments.[28] (See example of a GATS schedule of commitments.)

As previously noted, members were required in the services negotiations to specify the sectors and activities in which they were willing to undertake specific commitments, and these are listed in country schedules appended to the GATS. Articles XVI, XVII, and XVIII of the GATS are the core of the Agreement as far as specific sectoral commitments are concerned. Article XVI deals with market access, which is defined in a very specific manner. Having established that signatories will accord services and service suppliers treatment at least as favorable as that provided for in the schedules, the article goes on to define six types of market access restrictions that will not be adopted in respect of sectors where market access commitments are undertaken, unless there is a specification to the contrary in the schedule of specific commitments. In other words, disciplines on market access impediments will apply to scheduled commitments, unless a reservation is registered to the contrary. The six impediments or limitations on access are defined as (i) limitations on the number of suppliers, (ii) limitations on the total value of service transactions or assets, (iii) limitations on the total number of service operations or on the total quantity of service output, (iv) limitations on the total number of natural persons that may be employed, (v) measures that restrict or require specific types of legal entity or joint venture, and (vi) limitations on the participation of foreign capital. Article XVI limitations are exhaustive in the sense that these are the only limitations on market access that members are permitted to inscribe in their schedules.

Article XVII contains the national treatment provision. The approach here is very similar to that of market access, with national treatment applicable only to scheduled commitments, and only then if reservations are not made to the contrary. National treatment is defined in the traditional GATT manner[29] as treatment no less favorable than that accorded to domestic homologues, in this case services and service suppliers. Article XVII recognizes, however, that the attainment of national treatment may involve treatment that is not formally equivalent. As with market access, the greatest number of sectoral commitments subject to national treatment limitations is associated with the commercial presence and move-

Example of a GATS Schedule of Commitments

Service Activities	Mode of Supply	Limitations on Market Access	Limitations on National Treatment	Additional Commitments
Part I - Horizontal commitments				
All sectors	1. Cross border	None	None	
	2. Consumption abroad	None	None	
	3. Commercial presence	None	Subsidies for R&D	
	4. Temporary presence of natural persons	Unbound, except for intra-corporate transfers of executives and senior managers for initial stay of four years; extensions of stays subject to economic needs test	Unbound, except as indicated in market access column	
Part II - Sector-specific commitments				
Accounting services	1. Cross border	None	None	
	2. Consumption abroad	None	None	
	3. Commercial presence	Only natural persons may be registered as auditors	At least one equity partner in a firm must be a permanent resident	
	4. Temporary presence of natural persons	Unbound, except as provided in the horizontal section	Unbound, except as provided in the horizontal section	
Electronic data interchange	1. Cross border	None	None	
	2. Consumption abroad	None	None	
	3. Commercial presence	None	None	
	4. Temporary presence of natural persons	Unbound, except as provided in the horizontal section	Unbound, except as provided in the horizontal section	

ment of natural persons modes of delivery. A significant difference between national treatment in the GATT and in the GATS is that, in the former case, national treatment is established as a principle to be applied across the board,[30] whereas in the latter case, national treatment has been given negotiating currency—it is something to be granted, denied, or qualified, depending on the sector and signatory concerned.

Article XVIII offers the possibility for signatories to negotiate additional commitments not dealt with under the market access and national treatment provisions of Article XVI and Article XVII. These commitments could apply to such matters as qualifications, standards, and licensing, and would be inscribed in members' schedules. Limited use was made of this option in the Uruguay Round negotiations. The most important aspect of Article XVIII measures is that they must express commitments favoring more open access and not additional market barriers. Some members have used the additional commitments column to indicate future measures without a fixed date of implementation.

Commitments in Financial Services and Measures Relating to Prudential Regulation and Balance of Payments

Specific commitments in financial services are made in accordance with the Annex on Financial Services in addition to the provisions of Part III (Articles XVI, XVII, and XVIII) of the GATS. The Annex complements the basic rules and definitions adopted in the GATS, taking into account the specificities or the sector-specific characteristics of financial services.

The most important of the sector-specific provisions included in the Annex is paragraph 2(a) on the so-called prudential measures in domestic regulation. From the start of the negotiations on financial services during the Uruguay Round, negotiators recognized the need to maintain measures for protecting investors, depositors, and policyholders, and for preserving the integrity and stability of the financial system when making commitments to liberalize the supply of financial services to competition from foreign financial institutions. With the inclusion of this paragraph in the Annex, members are allowed to take such prudential measures. These measures need not be inscribed in the schedules of specific commitments of members, regardless of whether they are in conformity with Articles XVI(1) (market access) and XVII(1) (national treatment), so long as they constitute prudential measures as defined in the Annex. Where such measures do not conform with the provisions of the GATS, they shall, however, not be used as a means of avoiding the members' commitments or obligations under the GATS.

Although no further detail is given in the Annex as to what specific measures would actually constitute prudential measures, capital and reserve requirements, as well as licensing criteria imposed on financial institutions that are not more burdensome than necessary to ensure the solvency and the smooth operation of those institutions, would normally be considered consistent with this provision. The evolving process of regulatory harmonization and enhanced cooperation between financial regulators and supervisors in the context of the Bank for International Settlements and the International Organization of Securities Commissions, as well as in other international forums, provides useful background in maintaining discipline in the introduction and implementation of prudential measures based on this provision.

Other sector-specific provisions in the Annex include a provision to protect individual customer information and other confidential or proprietary information,[31] a provision on the recognition of prudential measures of other countries,[32] and a paragraph on dispute settlement stating the need to secure relevant expertise on panels for disputes in the area of financial services.[33] The part on definitions in the Annex provides a list of financial services used in the schedules of members.[34]

Many countries[35] have opted to undertake commitments in financial services using the Understanding on Commitments in Financial Services.[36] This document, which forms a part of the schedule of a member adopting it as a basis for making commitments, provides a standardized list of liberalization commitments in financial services. Most notably, it includes a general standstill commitment for financial services and the granting of the right to establish commercial presence to foreign financial service suppliers. It also contains a commitment to permit an established foreign financial service supplier to offer any new financial service. Other important provisions include a commitment not to take measures that prevent transfers of information or the processing of financial information, and provisions that elaborate on nondiscrimination with respect to market opportunities and national treatment for foreign financial service suppliers.

Except under Article XII, the GATS does not allow members to "apply restrictions on international transfers and payments for current transactions relating to its specific commitments."[37] The footnote to Article XVI also states that if a member undertakes a market access commitment in relation to the cross-border supply of a service and if the cross-border movement of capital is an essential part of the service itself, that member is committed to allow such a movement of capital.[38] If a member undertakes a market access commitment in relation to the supply of a service through commercial presence, that member is committed to allow related inflows of capital into its territory.[39]

Although these provisions apply to all services, they are particularly relevant in the context of financial services, since a commitment to liberalize market access in financial services would be virtually worthless without a concomitant obligation to liberalize associated capital flows.

On the other hand, Article XI(2) provides that nothing in the GATS affects

> the rights and obligations of the Members of the International Monetary Fund under the Articles of Agreement of the Fund, including the use of exchange actions which are in conformity with the Articles of Agreement, provided that a member shall not impose restrictions on any transactions inconsistently with its specific commitments regarding such transactions, except under Article XII or at the request of the Fund.

Although the full implications of this provision have never been tested, it sets the conditions under which a member is allowed to take exchange actions.

In the event of serious balance of payments and external financial difficulties or threat thereof, a member might wish to introduce restrictions of a temporary nature on trade in services for which it has undertaken specific commitments. In financial services, this might take the form of restrictions on international payments or transfers. Article XII lays down the conditions[40] and the procedures for invoking such measures, which involve notification and consultation with other members, with the IMF playing a crucial role in the process of establishing the legality of such measures under the GATS. More specifically, in the consultations with members,

> all findings of statistical and other facts presented by the International Monetary Fund relating to foreign exchange, monetary reserves and balance-of-payments shall be accepted and conclusions shall be based on the assessment by the Fund of the balance-of-payments and the external financial situation of the consulting Member.[41]

Financial Services 1995 Negotiations

Background

At the end of the Uruguay Round in December 1993, some 82 countries (counting at that time individually the 12 member states of the European Union) had commitments in financial services listed in their schedules of specific commitments. However, there was a view among some members that the commitments in a number of schedules were not sufficient to conclude the negotiations. In particular, the United States announced in 1993 that it would take a broad most-favored-nation

exemption in financial services unless the schedules of other countries were improved. This resulted in other countries also taking similar measures or withdrawing their previous best offers.

In order to avoid a breakdown of the negotiations, ministers agreed at the Marrakesh meeting of April 1994 that negotiations on commitments in financial services should be continued after the World Trade Organization (WTO) Agreement came into force.[42] The Second Annex[43] on financial services and a ministerial decision[44] provided members with the freedom to improve, modify, or withdraw all or part of their commitments in the financial services sector at the conclusion of a period ending six months after the entry into force of this Agreement. Members were also required to finalize their position relating to most-favored-nation exemptions in this sector at the same time.[45] It was agreed that, during the six-month period, any existing most-favored-nation exemptions that were conditional upon the level of commitments undertaken by other participants would be suspended. Although this period expired on June 30, 1995, it was subsequently extended by a decision of the Council for Trade in Services (the Council) until July 28, 1995.[46]

It was also specified in the ministerial decision that the Committee on Trade in Financial Services (the Committee) should monitor the progress of any negotiations undertaken under the terms of the decision to extend the most-favored-nation exemptions and should report thereon to the Council for Trade in Services.[47] Pending the creation of the Committee in January 1995, it was agreed that negotiations should be monitored by an Interim Group on Financial Services (the Interim Group), which met on three occasions until February 1995. After the creation of the Committee, it held ten formal meetings, from March until the end of July 1995 when the negotiations were concluded with an interim agreement.

Negotiations on the basis of the ministerial decision began on a bilateral level shortly after the Marrakesh meeting of ministers. These negotiations continued in capitals over the intervening period. Six rounds of intensive bilateral negotiations were held in Geneva until the end of June 1995, after which the deadline of the negotiations was extended by four weeks as mentioned. The bilateral negotiations were arranged in association with the meetings of the Interim Group or the Committee.

Outcome of the 1995 Negotiations

Participants agreed from the outset of the multilateral process that the objective of these negotiations should be to achieve a higher level of commitments on financial services on a most-favored-nation basis, and not to withdraw or scale down existing commitments. However, a number of participants made it clear that their ability to offer comprehensive

commitments, or to maintain their existing commitments, would depend on the quality and extent of the commitments made by others. On several occasions, the point was made that the outcome of these negotiations could not be seen in isolation from progress in concurrent negotiations on other subjects, in particular, the negotiations on the movement of natural persons.

In order to encourage the progress of the negotiations, it was agreed that those members who wished to do so should submit on a conditional basis their written intentions or conditional offers to the Secretariat. At the first meeting of the Committee on Trade in Financial Services held on March 28, 1995, several delegations that had submitted their written intentions stressed the need for further contributions by other participants and the urgency of rapid progress. At this meeting, the Committee agreed on a timetable for the concluding phase of the negotiations, in which delegations were requested to submit draft final schedules and draft final positions on most-favored-nation exemptions by June 15, 1995.

During the course of the negotiations, many countries reported on recent developments and liberalization measures in their financial services regimes in the meetings of the Interim Group or the Committee. These reports were considered extremely useful in improving the transparency of developments in regulatory regimes of members.

In the context of these reports, it was announced that Japan and the United States had decided to take measures regarding insurance in October 1994 and further measures regarding other financial services in February 1995. The measures taken by Japan were reflected in its revised schedule, and it was further confirmed that all the benefits of the measures taken were to be applied on a most-favored-nation basis consistent with WTO rules, and that Japan would provide any member, upon request, with information obtained for assessing the implementation of the measures.

Concluding Phase of the 1995 Negotiations

A senior-level meeting of the Committee on Trade in Financial Services was held on June 7, 1995. In this meeting, some new offers and intentions expressed were welcomed, but strong concern was also expressed that not enough progress had been made and that the offers of many countries contained absolute bars to new entry in important sectors or contained elements of discrimination against foreign financial service suppliers.

According to this view, several offers stopped short of protecting the so-called acquired rights of foreign firms that were established and oper-

ating in some of the markets. This was a case in which a foreign financial institution enjoyed a certain level of access into a country, such as having a branch or a majority-owned subsidiary, but the host country did not make a commitment in its schedule to protect or grandfather the present level of access, thus retaining the right to lower that level of access. It was not always possible, due to various domestic reasons, for countries to bind the status quo in a multilateral context, and it was also not true that bindings below present access levels had no value; nonetheless, efforts were thought necessary to resolve this issue in many countries.

Based on the view that not enough commitments had been put forward by other participants, the United States announced in the meeting of the Committee on June 29, 1995 that it had decided not to bind open the United States market nor guarantee national treatment for new entrants and new activities of foreign financial services suppliers. With the withdrawal of its best offer and the submission of a revised schedule and most-favored-nation exemption on June 30, 1995, the United States did not assume a most-favored-nation obligation that covered new activities in banking, securities, insurance, fund management, and other financial services. However, the U.S. delegation added that the United States had a long history of offering full market access to its financial markets, and this would remain its normal practice. The delegation also noted that the United States had no intention of imposing new restrictions on foreign financial services firms already established in the United States.

A large number of delegations expressed disappointment at this U.S. decision and stated their hopes that the situation would be reversed and that the United States would reconsider its position and come back to a firm and permanent most-favored-nation-based commitment. A risk emerged that the commitments negotiated during the course of the Uruguay Round and in the extended negotiations in the past year might be downgraded, effectively meaning a breakdown of the negotiations.

Given this situation at the end of June 1995, which was the initial deadline for the negotiations, the Committee sought a way for providing time to find a multilaterally acceptable solution and, therefore, agreed in its sixth meeting on June 30, 1995 to extend the period in which countries were allowed to make changes to their schedules of commitments and most-favored-nation exemption lists until July 28, 1995. This was made legally possible by a Decision by the Council for Trade in Services taken pursuant to paragraph 3 of the Second Annex on Financial Services, which gave the Council the power to establish any procedures necessary for the application of the provisions of the Annex.

In an attempt to reach an agreement on a multilateral basis despite this situation, the delegation of the European Community proposed that all

participants maintain their best offers on a most-favored-nation basis for a limited period of time. The time period of this agreement was proposed to be until December 1997. A great majority of countries expressed support for this proposal, and the Committee decided to adopt this interim solution. With the exception of a few countries, the best offers negotiated in the Uruguay Round and in the extended negotiations would be implemented on a most-favored-nation basis to all members for a period of two and a half years. To this end, the Committee, at its eighth meeting on July 21, 1995, adopted the text of the Second Protocol to the GATS[48] (the Protocol) and the Decision Adopting the Second Protocol to the GATS[49] and recommended to the Council for Trade in Services to adopt the Decision on Commitments in Financial Services[50] and the Second Decision on Financial Services.[51] The Council adopted these decisions in a meeting held on the same day.

As mentioned previously, some members had made their offers in financial services conditional on improved offers of other members in the area of movement of natural persons. The Negotiating Group on Movement of Natural Persons held its meetings in parallel with the meetings of the Committee, and a total of six countries made offers to improve their schedules in the movement of natural persons. These offers were subsequently confirmed. This development contributed to the conclusion of the negotiations on financial services in 1995.

Results of the 1995 Negotiations

The results of the financial services negotiations in 1995 were actually extensions to the results of the Uruguay Round negotiations concluded in December 1993. They revised or supplemented the national schedules and most-favored-nation exemptions submitted then, which need to be read together with the previous schedules and most-favored-nation exemptions. In all, 32 countries (counting the European Union as one) decided to revise or supplement their schedules or most-favored-nation exemptions in 1995.[52]

Of the 32 countries, all except Colombia, Mauritius, and the United States, agreed to accept the Second Protocol.[53] Among the 29 countries accepting the protocol, 20 made improved commitments in insurance, 24 in banking, 17 in securities, and 25 in other financial services. Thirteen countries revised most-favored-nation exemptions in financial services, of which 8 deleted, 2 suspended, and 3 reduced their scope or made other changes. These revisions or supplements were annexed to the Protocol and took effect when the Second Protocol entered into force, as explained further in this chapter.

The three countries not accepting the Protocol submitted revised commitments or most-favored-nation exemption lists or both. These revisions or supplements took effect on their respective dates of submission before the end of July 1995. Although they were not annexed to the Protocol, they formed an integral part of the results of the negotiations. No country withdrew its commitments in the financial services sector as a result of the negotiations.

It is not always easy to judge the value of the numerous entries in a country schedule or most-favored-nation exemption list. However, it can be said that many Asian, Latin American, and East European countries made significant improvements in their schedules and most-favored-nation exemptions in 1995 compared to those at the end of the Uruguay Round. Other countries maintained their best offers made at the end of the Uruguay Round.

The Protocol entered into force on September 1, 1996 for a large majority of countries. For the remaining countries, the Protocol entered into force 30 days after each acceptance. Two countries (Belgium and Brazil) were not able to ratify the Protocol because of procedural delay. During the period prior to the entry into force of the Protocol, members had undertaken not to take measures that would be inconsistent with their undertakings resulting from the negotiations, to the fullest extent consistent with their existing legislation.

Beginning November 1, 1997, WTO members again had the possibility during a period until December 12, 1997 to modify or withdraw the commitments in their financial services schedules and/or to take most-favored-nation exemptions in the sector.[54] If the Protocol had not entered into force, such a possibility to modify or withdraw commitments and/or to take most-favored-nation exemptions would have arisen during a period of 60 days beginning on August 1, 1996. These possibilities to modify or withdraw the commitments applied to all members of the WTO, not just to the 29 members that agreed to accept the Second Protocol.

With the accession of least-developed countries, as well as a number of other countries, and with one country (Kuwait) submitting for the first time a schedule of specific commitments in financial services as a result of the negotiations, the total number of countries with commitments in financial services was 95 as of end-December 1996. Upon the enlargement of the European Union to 15 member states, the number of schedules stood at 81, counting the EU as one. As more new members are acceding to the WTO, the number of members with financial services schedules is increasing continuously.

In the WTO Singapore Ministerial Declaration of December 13, 1996, it was agreed that financial services negotiations would resume in April

1997, with the aim of achieving significantly improved market access commitments with a broader level of participation in the agreed time frame. (See Addendum.)

Conclusions

Innovation in information technology and the use of such technology in financial transactions have integrated world financial markets. Liberalization of limitations on financial services trade can be seen as simply endorsing what market forces might already have achieved or are about to achieve. However, in order to remove existing distortions and create a truly efficient and functioning global marketplace for financial services, further work is necessary in a multilateral context. The GATS provides a unique tool to accomplish such a goal to provide the foundations for a liberal trading system for financial services from which all countries would benefit.

The process for liberalizing financial services trade under the GATS is still in a relatively early stage. Future negotiations will be required to accomplish free trade and guaranteed rights of establishment in all of the major and emerging financial markets around the world. This being said, what has already been achieved is no small step toward this ultimate goal. Members of the WTO are benefiting from improved commitments, resulting from the financial services negotiations. Together with the results of the Uruguay Round, they already form a vast array of undertakings by countries to promote liberalization in financial services trade. The commitments bring new opportunities and greater security for investors in banking, securities, insurance, and other financial services. They help promote merchandise trade and other services trade, where access to efficient financial markets and services is critical. They facilitate capital flows to developing and transition economies. The commitments contribute to the development of financial markets that are necessary for economic development and growth.

Addendum

The above chapter explained the history of the financial services negotiations at the WTO in 1995, which resulted in an interim agreement until December 1997.

As a result of the negotiations concluded on December 12, 1997, a new and improved set of commitments in financial services under the GATS was agreed upon on a permanent basis. A total of 56 schedules of commitments, representing 70 WTO members has been annexed to the

Fifth Protocol to the GATS, which will be open for ratification and acceptance by governments until January 29, 1999. The new financial services schedules are expected to enter into force by March 1, 1999.

Five countries (Bolivia, Costa Rica, Mauritius, Senegal, and Sri Lanka) offered to make commitments in financial services for the first time in the course of the most recent negotiations, increasing the total number of WTO members with commitments in financial services to 102 upon the entry into force of the Fifth Protocol. With the addition of Bulgaria, Hungary, New Zealand, Nigeria, and Sri Lanka (excluding insurance for this country), 32 countries (counting the EU member states and Aruba individually) have now adopted the Understanding on Commitments in Financial Services as the basis for their commitments.

The United States, India, and Thailand withdrew their broad most-favored-nation exemptions based on reciprocity as a result of the negotiations. Several countries, including Hungary, Mauritius, the Philippines, and Venezuela, reduced the scope of their most-favored-nation exemptions. A small number of countries submitted limited most-favored-nation exemptions or maintained existing broad most-favored-nation exemptions. The United States submitted a limited most-favored-nation exemption in insurance, applicable in a circumstance of forced divestiture of U.S. ownership in insurance service providers operating in WTO member countries.

The new commitments contain significant improvements in allowing, inter alia, commercial presence of foreign financial service suppliers by eliminating or relaxing limitations on foreign ownership of local financial institutions; limitations on the juridical form of commercial presence (branches, subsidiaries, agencies, representative offices, etc.); and limitations on the expansion of existing operations. Important progress was also made in "grandfathering" existing branches and subsidiaries of foreign financial institutions that are wholly or majority-owned by foreigners.

A nonattributable summary of the main improvements included in the newly agreed-upon commitments is available from the WTO Secretariat at the WTO's website: http://www.wto.org.

COMMENT

DEBORAH E. SIEGEL

A Comparison of Approaches in the North American Free Trade Agreement and the General Agreement on Trade in Services: The Negative List and Positive List Approaches

This comment examines some practical points about drafting an agreement on financial services, based on the comprehensive description of the General Agreement on Trade in Services (GATS)[1] provided in Chapter 18.

As described in Chapter 18, the GATS contains some general obligations, but its structure is such that members provide the vast majority of sectoral commitments in their schedules. This model has been called the "positive list" approach, in that the parties "positively" state their commitments in the schedules. It is also called the "bottom-up" approach, in that the parties are building a package of specific commitments from the bottom.

By comparison, an international agreement that took an opposite approach on services is the North American Free Trade Agreement (NAFTA) between Canada, Mexico, and the United States.[2] The NAFTA is called the "negative list" model, because it establishes most of the substantive obligations in the text, and the schedules list reservations to, or exclusions from, the general obligations.[3] It is also called the "top-down" or "formula" approach.

In general, it seems fairly clear that the so-called negative list approach used in NAFTA is more effective in achieving further liberalization, which was the intent of the parties to the NAFTA from the outset. There was not only the goal of opening the other parties' markets, but there was a recognition of the domestic benefits of opening one's own markets in terms of fostering foreign investment. Furthermore, an international agreement could serve to solidify progressive policies that had been instituted on the domestic front—a motivation reasonably attributable to Mexico, given the expansive reform in that country at the time NAFTA was negotiated. Other aspects of domestic politics that may influence the negotiation of an international agreement, such as the dynamics between a federal government and a state or local government or vis-à-vis a protectionist domestic industry, are addressed in the other comment to Chapter 18.

Even if one seeks to achieve extensive liberalization, using the negative list has certain disadvantages. "It was like hanging out your dirty laun-

dry," said one U.S. NAFTA negotiator. Domestic measures that are discriminatory or otherwise restrictive need to be spelled out in the schedules in order to be reserved. These measures are consequently highlighted and effectively advertised to other countries, thus inviting questions about them in future negotiations. Furthermore, this "advertisement" must be very clear, as any measure that is not clearly included in the schedule is not reserved. The failure to note a measure in the schedule means it will be subject to the general obligations established by the treaty.

The positive list approach, in contrast, while perhaps generating more modest results, appeared particularly useful in the GATS situation. Many countries resisted including services in the Uruguay Round at all when the negotiations started.[4] By giving the parties the discretion to craft their obligations, the positive list approach helped convince reluctant countries to become participants and permitted the Uruguay Round to subject services to a set of multilateral disciplines. The schedules are not completely discretionary of course, because the commitments are negotiated; nonetheless, this process leaves a fair bit of control to each negotiating party. Additionally, it becomes evident, when comparing specific provisions of the two agreements, that the GATS provisions are not only different from the NAFTA provisions, they are different from one another. The various provisions of the GATS, while ultimately permitting discretion on the content of the schedules, create different presumptions of what is to be included. The extent of this presumption can create a dynamic in the negotiations that can affect the outcome.

This comment reviews a few provisions in the text of the two agreements, focusing on the aspects relating to these bottom-up or top-down approaches, while leaving aside stylistic and other types of differences. First, it examines three main substantive obligations—national treatment, market access, and most-favored-nation treatment. Second, the comment reviews two main exceptions particularly important for financial services—one on governmental activities, such as monetary and exchange rate policies, and one on measures taken for prudential reasons.

Substantive Obligations

National Treatment

The national treatment provisions of the two agreements provide the clearest and most straightforward examples of textual variations required by the two approaches. The NAFTA creates a general obligation to provide national treatment:

> *Each Party shall accord to investors of another Party* treatment no less favorable than that it accords to its own investors, in like circumstances, with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of financial institutions and investments in financial institutions in its territory.[5]

In this provision, the clause "[e]ach Party shall accord . . ." establishes the general obligation. Nonetheless, this general obligation is subject to reservations. Article 1409 provides, for all the substantive provisions reviewed here, the right to list nonconforming measures in an accompanying schedule. The reservations create the "negative list."

In contrast, the GATS provision clearly indicates that the national treatment provision applies only to sectors identified in the schedules.

> *In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein*, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favorable than that it accords to its own like services and service suppliers.[6]

Thus, for a service or sector to be subject to the national treatment requirement, a member must "schedule" it, as indicated by the clause "[i]n the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein. . . ."[7]

How does the national treatment obligation apply to financial services, for example, to a rule to apply national treatment for the establishment of banks? Assume that a regulatory agency decides that a geographic area is "overbanked," that is, that the market is saturated with banks at that time, and it rules that there should be no new banks in that geographic area. This rule applies to domestic as well as foreign banks. To determine if this is a violation of national treatment, the first question is whether the party is obliged under the treaty to allow the establishment of banks. Under the NAFTA, this is a general rule, unless specifically excluded by the schedules. In the GATS, however, this obligation applies only if the party specifically committed to it.

Once it is established that the obligation applies, the second question is one of interpretation. Some argue that, because the preclusion would apply to new banks of any kind, there is no discrimination between domestic and foreign banks and no national treatment violation. However, the issue gets more complicated if the market had never been open to foreign banks. In that case, it would have to be determined whether a preclusion against new banks that is *de jure* consistent with national treatment (because it does not discriminate between domestic and foreign banks) is nonetheless *de facto* precluding any opportunity for foreign banks to compete. For both treaties, questions of this nature will need to be resolved in

practice. Any interpretation of a general obligation under NAFTA would presumably apply to all parties to the agreement, while an obligation created by the individual schedules under the GATS is potentially subject to a different interpretation for each member, depending on the presentation of the obligation in the schedules.[8]

Market Access

The provisions requiring market access, which are more complex than the national treatment provision, reveal several interesting differences between the two approaches. The NAFTA rules on market access are spread out in several provisions but are divided into two main headings—the right of establishment and cross-border trade in services. On the right of establishment, each NAFTA party must permit individuals and companies from the other NAFTA countries to establish financial institutions in its territory and to expand the operations of such institutions throughout its territory.[9] This benefit is limited to financial service providers, so that to be eligible for the benefits on market access set forth in NAFTA's chapter on financial services, the entity must already be engaged in the business of providing financial services in its own territory.[10]

On cross-border trade, NAFTA has two relevant provisions. First, there is a "standstill" obligation under which a NAFTA party may maintain its existing measures regulating cross-border financial services and mobility of providers, but it may not adopt any new measures increasing existing restrictions on cross-border services permitted on the date NAFTA entered into force, unless otherwise provided in the schedules.[11] This first provision relates to the "mobility of service providers" in the sense that it applies to the ability of a provider to sell financial services in a jurisdiction where it has no place of business.[12]

The second provision has been referred to as involving the "mobility of consumers," in that it ensures the ability of the consumer to purchase services from a provider located outside the consumer's jurisdiction of residence. The provision states that

> [e]ach Party shall permit persons located in its territory, and its nationals wherever located, to purchase financial services from cross-border financial service providers of another Party located in the territory of that other Party or of another Party.[13]

The provision does not require allowing such providers to "do business or solicit in their territory," and it permits each party to define "doing business."[14] There is also a provision on senior management and boards of directors.[15]

As is the case with the provision on national treatment, under Article 1409 these market access provisions are subject to reservations on nonconforming measures—the "negative list."

The GATS provision, consistent with the positive list approach, refers to the schedules where the obligations must be "positively" listed.

> With respect to market access through the modes of supply identified in Article I, each Member shall accord services and service suppliers of any other Member *treatment no less favorable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule.*[16]

Under this positive list approach, it is clear that the commitments must be "scheduled," as indicated by the clause "treatment no less favorable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule." It was intended that the commitments included in the schedules would be provided to *all* members, following the most-favored-nation principle addressed in the next part of this comment. Under this approach, a member could not offer a commitment by making it subject to reciprocal treatment from other members, because it does not indicate which other members reciprocate on that point; exceptions to the most-favored-nation principle were to be listed in a special annex for that purpose.[17] In practice, some schedules were reportedly written specifying commitments to some members but not others.

A comparison of the NAFTA and GATS provisions on market access shows that the design of an international agreement has important implications for drafting techniques. The mention of Article 1 in the GATS provision refers to the four modes of supply defined by the GATS, as explained in Chapter 18, thereby addressing all the methods of supplying a financial service in one article on market access. The NAFTA, in contrast, has several provisions on market access. While there are certain differences concerning the modes of supply, the following point relates to the "negative list" and "positive list" approaches. For the NAFTA, because the right of establishment is a general obligation, it is necessary for the text to spell out all its features. The text does so in Article 1403, taking five paragraphs to define this right. For the GATS, however, the right of establishment or commercial presence is a scheduled commitment (under the third mode of supply) and is to be defined in the schedule, rather than in the agreement.

There are also different drafting techniques within the GATS itself. In Paragraph 2 of the article on market access, the text contains a list of six market access disciplines that are presumed to apply to scheduled commitments, unless the schedules specifically exclude them.

> In sectors where market-based commitments are undertaken, the measures which a Member shall not maintain or adopt either on the basis of a regional subdivision or on the basis of its entire territory, ***unless otherwise specified in its Schedule***, are defined as: [(a) through (f)] . . .[18]

The limitations that are listed in (a) through (f) involve (a) the number of service suppliers permitted, (b) the total value of service transactions, (c) the total number of service operations, (d) the total number of employees, (e) the type of legal entity necessary to provide a particular service, and (f) the participation of foreign capital.

The GATS thus blends the two approaches in this single provision in the sense that there is a negative list within the positive list. Agreeing to the right of establishment in the schedules is a positive list approach, but adding the limitations is a negative list. For example, if a country scheduled commitments to allow banks to be established in their territories, this commitment would not be subject to any of the limitations listed unless specifically noted in the schedules. In sum, the result of this formulation may be described as creating a presumption that a liberalized measure will not be subject to the specified limitations because the member must affirmatively list them. In practice, the presumption is often overturned because, as previously indicated, for the one case of right to establishment, limitations are quite prevalent in the schedules.

The GATS market access provision contains specific rules on the movement of capital associated with a certain type of commitment.[19] If a member undertakes a market access commitment in relation to the cross-border supply of a service and if the cross-border movement of capital is an essential part of the service itself, that member is committed to allow such movement of capital. If a member undertakes a market access commitment in relation to the supply of a service by allowing commercial presence in its territory, that member is committed to allow all related transfers of capital into its territory. In contrast to the six market disciplines previously described, the member may not make an exception to this requirement if it notes a reservation in the schedule.

Most-Favored-Nation Treatment

In the NAFTA and the GATS, the most-favored-nation provisions use the negative list approach, that is, both treaties establish general obligations that may be subject to exceptions. Despite drafting style differences between the two provisions, the substance is similar. The most-favored-nation provision under NAFTA is as follows:

> ***Each Party shall accord*** to investors of another Party, financial institutions of another Party, investments of investors in financial institutions and cross-border financial service providers of another Party treatment no less favor-

able than that it accords to the investors, financial institutions, investments of investors in financial institutions and cross-border financial service providers of any other Party or of a non-Party, in like circumstances.[20]

The GATS most-favored-nation rule provides:

With respect to any measure covered by this Agreement, ***each Member shall accord*** immediately and unconditionally to services and service suppliers of any other Member treatment no less favorable than that it accords to like services and service suppliers of any other country.[21]

By stating that each Party or Member "shall accord" most-favored-nation treatment, both treaties create a general obligation. Nonetheless, both treaties also specifically provide for scheduling exceptions. Under NAFTA, Article 1409 permits reservations. Under the GATS, an annex contains rules on measures that do not conform to this obligation.[22]

It is noteworthy that the ultimate effect of this general obligation depends on the style of the reservations. The GATS text may look more expansive on its face, because it requires most-favored-nation treatment to be afforded "immediately" and "unconditionally," but the early results of the negotiations were more restrictive because of the extensive reservations that were taken at that time. In contrast, the annex governing exemptions to most-favored-nation status limits these reservations by stating that any exemption should apply for only ten years "in principle" and would be subject to review in five years.[23] While not setting an expiration date for exceptions, the annex creates some momentum for their elimination. Also, the exemptions were meant to be a "one-shot deal," in that they could not be added to in the future.

Therefore, while both the GATS and NAFTA use the same negative list approach, results may ensue, depending on the permissible scope of exemptions.

Exceptions

There are two exceptions in both agreements that are particularly significant for financial services—one on governmental activities, such as monetary policy, and one on prudential measures. While not technically using the negative list or positive list approaches, these exceptions demonstrate analogous techniques of "inclusive" or "exclusive" drafting to define the obligations established in the treaty.

Monetary Policies

The first exception perhaps most relevant to central bankers relates to governmental services, such as monetary or exchange rate policy.

The NAFTA text is straightforward on this point.

> Nothing in this Part applies to non-discriminatory measures of general application taken by any public entity in pursuit of monetary and related credit policies or exchange rate policies. . . .[24]

By referring to "Nothing in this Part," the NAFTA makes this exception applicable to the chapters included in the same part of the agreement as financial services, which covers investment generally, cross-border trade in services generally, telecommunications, competition policy, and temporary entry for businesspersons. The exception thus appears rather broad.

Compare the NAFTA provision to the GATS provision, however, where monetary and exchange rate policies are carved out of the definition of "services," which determines the scope of the agreement at the outset. Under GATS, a service includes any service in any sector except "services supplied in the exercise of governmental authority,"[25] and the Annex on Financial Services indicates that such services include monetary and exchange rate policy.

There are three types of activities listed: monetary or exchange rate policies conducted by a central bank or monetary authority; social security or public retirement plans; and other activities conducted by a public entity for the account of, with the guarantee of, or using the financial resources of the government.[26] If either of these last two activities are turned over to the private sector, they are within the definition of services, which reflects the small likelihood that monetary or exchange rate policies would be conducted by a private entity.

How are these provisions affected by the positive list and negative list approaches? Take a hypothetical example relating to the right to manage newly privatized pension funds. First, consider how the GATS would apply. While handled by the government, the management of pension funds is excluded from the agreement, and consequently, the general obligations, including the requirement for most-favored-nation treatment, do not apply. Once the management of the pension funds is privatized, however, under Paragraph (c), management is included in the definition of services. This service is then subject to the general disciplines under the agreement, such as most-favored-nation treatment. Therefore, if the member were to open up this service to one member, it would have to make this service available to all members under the same terms unless it made a most-favored-nation reservation. However, if the member has not "scheduled" asset management under the GATS, it is not subject to national treatment or market access requirements that apply only according to the positive list, and, therefore, there is no obli-

gation to allow pension fund managers from other members to bid for this service.

Under NAFTA's negative list approach, once pension management is privatized, it is subject to all provisions of the Chapter on Financial Services, and it would be subject to the national treatment and market access requirements.

For monetary or exchange rate policies, which are not likely to be privatized and therefore would remain excluded, it seems, at first glance, that there is little difference resulting from this "inclusive" or "exclusive" style of defining services and the exceptions. A difference may arise, however, in a dispute settlement context. While these are obvious cases (neither agreement intends to extend its obligations to these kind of governmental policies), the treaties may have different results in response to a possible claim by a party under a "non-violation nullification or impairment" claim. Such a claim would state that, even though a measure does not violate the terms of the agreement, it so affects the benefits that another party expected to accrue from the agreement that it warrants providing compensation to that other party. A dispute resolution panel interpreting the GATS would likely rely on the GATT jurisprudence that establishes criteria for this type of claim.[27]

Under the NAFTA, a claim that expected benefits were nullified or impaired does not appear to be precluded. The claim would be a case of "nonviolation," since, as an exception to obligations, monetary policies are grounds to derogate from the negotiated obligations. However, these negotiated obligations form part of the expected benefits under the agreement, and if the monetary measures somehow nullify or impair these expected benefits, there would appear to be grounds for a challenge. In the GATS, in contrast, these policies are excluded from the scope of the agreement at the outset and cannot form a part of the expected benefits. Thus, a change in monetary policies could not give rise to a claim that these expected benefits were nullified or impaired. The GATS does not appear to afford the possibility of a nullification or impairment claim on monetary policies, such as exchange rate measures, as appears to be the case under the NAFTA.

The NAFTA provision may also provide less protection to monetary and exchange rate policies because, under usual norms of statutory and treaty construction, exceptions are to be narrowly construed. Therefore, if a question of interpretation arose as to whether a measure is meant to be included, it is possible that a dispute resolution panel would reach different conclusions when analyzing the two treaties, given the presumptions created by the structure of the provisions. The breadth of the

exception on monetary and exchange rate policies is another question that will have to be answered in practice.

Prudential Measures

The exception for prudential measures is worth mention, as it is essential to any agreement on financial services. The exceptions contain essentially the same substance under the two agreements, although structured differently. One striking difference, however, is that the NAFTA refers to "reasonable" prudential measures that are permitted,[28] but the GATS does not use the term "reasonable."[29] Is the NAFTA exception on prudential measures more limited than the corresponding exception in the GATS? In this case, the answer is probably no. As other writers on the NAFTA have pointed out, the term "reasonable" is likely to be viewed as requiring a review of the policies behind the measure and the actual effects; in other words, requiring a member to balance the trade restrictive effects against the value of the measure to achieve a kind of proportionality between the problem and the repercussions of the solution.[30]

While the GATS provision does not use the word "reasonable," the provision should be interpreted as implicitly including this term. Chapter 18 suggests this interpretation. It describes various prudential measures and states that "capital and reserve requirements, as well as licensing criteria imposed on financial institutions *that are not more burdensome than necessary to ensure the solvency and the smooth operation of those institutions*, would normally be considered consistent with this provision."[31] This "not more burdensome than necessary" standard is a trademark of GATT panel reports interpreting the scope of the exceptions to the GATT and is likely to be applied to the GATS.[32]

The difference between the NAFTA and GATS provisions on the use of the term "reasonable" appears to be one of style only, perhaps depending on the traditions of the drafters as to their needs to make certain points of interpretation explicit in the agreement.

Conclusion

In sum, the NAFTA and the GATS provide negotiators of any future agreements on the liberalization of financial services with different models from which to choose. In the few provisions reviewed, there is a range of styles with differing levels of commitments. In the negative list approach, the text creates general obligations but permits reservations. This approach was generally used by the NAFTA, but the GATS most-favored-nation provision is also an example. The GATS also showed sev-

eral variations on the positive list approach. The general theme of this approach is that the parties list their substantive obligations in schedules. This is essentially voluntary. The text can add a spectrum of variations, however, by prescribing what may be in the schedules; what must be in the schedules (such as the rules on capital movements); or what is presumed to be in the schedules (such as the six disciplines concerning market access). Due in part to these different presumptions created under the various provisions, the GATS agreement on financial services is a complex web of commitments and obligations.

COMMENT

MARILYN L. MUENCH

This comment is intended to step back from the broad multilateral picture to look at some of the domestic considerations—often intensely practical and political—that can accompany international negotiations in financial services. Some of the factors that must be taken into account so that a country can be prepared to negotiate knowledgeably and effectively on an international basis in the sector are considered. Naturally, the particular issues that bedeviled U.S. negotiators during the Uruguay Round negotiations might not be a problem in all countries. However, the financial services sector has certain characteristics that increase the likelihood that countries undertaking such negotiations will face a number of common issues.

First, in nearly all countries financial services tend to be highly regulated. Regulators are likely to have a keen interest in ensuring that their ability to regulate for prudential reasons is well protected. In many countries, financial services regulators are not usually participants in trade negotiations. Therefore, it is often necessary to work out methods of cooperation and consultation with the trade ministries or other agencies that typically undertake trade negotiations.

Second, there is often considerable legislative interest in the conduct and outcome of financial services negotiations. Accordingly, domestic industries might take an active interest in the negotiations. In some cases, these companies might be hoping that negotiations will create new opportunities. At other times, they might be more interested in seeking to preserve certain protections that benefit them in the existing system.

These are some of the major factors that influence the conduct of financial services negotiations in general. These factors are examined in light of circumstances in the United States and how they affected the experience of U.S. negotiators in the Uruguay Round negotiations.

Getting Started: The Negotiations

The complexity of the U.S. financial system made it difficult to prepare for the negotiations in the Uruguay Round. The U.S. regulatory scheme in banking, securities, and insurance is not a model for the rest of the world. It is a complex system that someone setting out to establish a rational order for financial services might not deliberately design.

The United States regulates banking and securities on both the federal (or national) level and the state (or subnational) level. Examples of federal regulatory agencies are the Office of the Comptroller of the Currency (OCC), which is part of the Treasury Department and regulates nationally chartered banks; the Board of Governors of the Federal Reserve System, which, among other responsibilities, regulates bank holding companies while also playing a significant regulatory role with respect to foreign bank branches and agencies, whether chartered by the federal or state government; and the Securities and Exchange Commission (SEC), which regulates securities issuance and trading.

Federal law takes precedence in these matters, and Congress can, if it wishes, overrule or displace state regulation in many areas. However, banking regulation and securities regulation in actuality are generally concurrent. In other words, both federal and state laws exist at the same time, and many financial institutions, to their dismay, find themselves subject to laws at both levels. This system forced the United States to ensure that its international negotiating positions took into account state regulation and did not concentrate only upon the federal level. Moreover, an added difficulty with respect to insurance is that all U.S. regulation is at the state level, with no federal regulation at all.

This complex regulatory system gave rise to certain implications. First, U.S. negotiators had to consult with state regulators in all three of the substantive financial services fields—banking, securities, and insurance. Second, they needed to acquire sufficient expertise so that they could adequately explain the complicated U.S. system in the context of negotiations. Having recognized the various levels of regulation, it was necessary to figure out how to go about putting together a knowledgeable negotiating team to start work on financial services in the Uruguay Round.

In the 1970s and 1980s, the United States was an early and enthusiastic proponent of the expanded system of the General Agreement on Tariffs and Trade (GATT). U.S. financial services companies were in the vanguard. They were interested in the expansion of the system and hoped that market access could be achieved through a services agreement under GATT auspices. The objectives were relatively simple: U.S. companies wanted to maintain and lock in the relatively good access they enjoyed in a number of countries, but they wanted better access and national treatment in certain other countries.

In the U.S. government, trade negotiations are primarily the responsibility of the office of the U.S. Trade Representative (USTR). This began the overall negotiations on all agreements in the Uruguay Round when the round was launched in 1986. The USTR carried the negotiations forward into 1989, when financial services experts became involved for the

United States. The United States decided that its financial services team would initially involve representatives of the federal banking regulators: the Federal Reserve; the OCC; the SEC as the federal securities regulator; and the Treasury Department because of its monetary and international economic policy responsibilities, which include financial services. The Treasury Department and the other regulators had responsibility for handling banking and securities issues in the Uruguay Round negotiations, while the USTR and the Department of Commerce handled insurance—the one area that was not federally regulated. The observations that follow apply mostly to banking and securities.

Some initial questions arose between the financial regulators and the USTR concerning who should attend certain meetings and who should be considered the head of the delegation. These questions required some consultation to resolve. However, satisfactory arrangements for effective participation by the financial services experts were achieved. Their participation was important, because the USTR is a relatively small agency, and it lacks substantive expertise in this area.

The early team of financial services experts, having determined to start on negotiations, arrived in Geneva to find that the General Agreement on Trade in Services (GATS)[1] did not appear particularly well equipped to handle the special needs of the financial services sector. In order to address this problem, an informal group of financial services experts from a number of industrialized and developing countries gradually arose because of the common desire to see that the GATS dealt adequately with the sector. By 1989, in a preliminary draft, the GATS looked suspiciously similar to the GATT. Although it did not have any tariff provisions, it did have clauses on dispute resolution, payments and transfers, a balance of payments exception, and a most-favored-nation clause.

For financial services experts, a serious deficiency in the preliminary GATS draft was its lack of any special consideration for financial services. U.S. financial services experts believed that the financial services sector was highly regulated virtually all over the world, with special characteristics that needed to be recognized and, where necessary, protected. It was not only that financial services were not goods, like widgets, or commodities, like soy beans, but that financial services were not necessarily like other services. They bore little resemblance to tourism, and they were not like legal services or accountancy, either.

There was one particularly overriding concern for financial services regulators: to protect their ability to regulate on prudential grounds in order to insure the safety and soundness of the financial system and to protect the consumers of financial services. This goal was shared by all of the U.S. financial services negotiators from the beginning. As time went on, it

became clear that this objective was almost universally accepted, because all countries came to recognize the value of such a prudential carveout.

Another idea that emerged quite naturally was the need to include an annex to the GATS that dealt specifically with the needs of the financial services sector. By the end of 1990, when the Uruguay Round was originally to have been completed, the idea of an annex had become generally accepted. The resulting Annex on Financial Services contains a number of useful provisions.[2] First and foremost is the prudential carveout, which is set forth in Paragraph 2(a) of the Annex.[3] The Annex also has a broad, open-ended listing of activities that are considered to constitute financial services.[4] Moreover, it defines what governmental services mean in the financial services context and provides that certain governmental activities are not covered, such as the activities of a central bank in pursuit of monetary or exchange rate policies.[5]

Legislative and Industry Concerns

While the negotiations in Geneva were occurring, the U.S. financial services negotiators were in contact both with members of Congress and with members of the financial services industry. This practice was a matter of law and political realities. As far as the law was concerned, the United States in 1974 passed a new trade act that established a number of procedures for the conduct of trade negotiations.[6] One of the most important aspects of the law was its creation of the so-called fast track process.[7] Fast track sets up a special procedure that provides an expedited timetable for consideration of international agreements by Congress and, significantly, permits no amendments.[8] Fast track is essential for trade agreements in the United States, because so many interests are affected. The temptation of Congress to amend the agreements had proven nearly irresistible in the past. Before fast track, trade agreements were regularly amended to such an extent that they sometimes no longer resembled the agreement originally negotiated. Fast track attempted to overcome this problem.

The 1974 Trade Act also incorporated a number of provisions to ensure that Congress and the industries concerned would be kept involved in the negotiation process.[9] Although Congress voluntarily adopted the special fast track procedures that limited its own powers, it still retained the power simply to refuse approval of an agreement if it did not like its provisions. Accordingly, it was prudent for the USTR to keep Congress up to date on developments. The 1974 Trade Act also envisaged the establishment of industry advisory groups.[10] There was an active group of banks, securities firms, and insurance companies in the financial

services group with which the Uruguay Round negotiators met regularly. One purpose of these regular contacts was to apprise the industry of recent developments, but another purpose was to elicit information that would aid in the bilateral request-offer exercise in the negotiations. This exercise was part of the process in the Uruguay Round by which each country ultimately decided on its scheduled commitments in financial services and discussed their own commitments with other countries.

The existence of fast track is important for successful trade negotiations by the United States. Concerns arose over the ability of the United States to continue participation when the Uruguay Round was not completed in 1990 as originally scheduled, and subsequently in 1991 and 1992. Fast track was due to expire on June 1, 1993,[11] which was before anyone realistically believed that the Round could be completed. Moreover, a change of administrations in the United States made it difficult to determine what the new administration was going to do. As it turned out, the uncertainty was resolved early in 1993 after the new administration committed itself to completing the Uruguay Round. Congress and the administration reached agreement on an extension of fast track procedures through December 15, 1993.[12] This date became the decisive date for the United States and had a clear influence on the overall date for ending the Uruguay Round. It also seems likely that everyone was seeking some excuse for a final deadline, given the sheer fatigue that comes from negotiating nonstop for more than seven years.

Financial services negotiations were not, however, completed by December 15, 1993. Instead, the Uruguay Round's package of documents permitted negotiations on financial services to take place during the first six months after entry into force of the agreement that established the World Trade Organization (WTO)—January 1, 1995.

By that time, in the United States there was another legislative requirement with which to contend. Using the fast track process, legislation was adopted in the United States that allowed the WTO agreements to enter into force on January 1, 1995.[13] However, that law specified that financial services negotiations would continue and established certain requirements for the extended negotiations.[14] First, the legislation established objectives for the negotiators. Briefly, these objectives were

> to secure commitments, from a wide range of commercially important developed and developing countries, to reduce or eliminate barriers to the supply of financial services, including barriers that denied national treatment or market access by restricting the establishment or operation of financial services providers. . . .[15]

In the Statement of Administrative Action that accompanied the legislation, the Administration undertook to provide an interim report to

Congress as of April 30, 1995, describing the status of the then ongoing negotiations. In addition, the Administration agreed to consult with Congress and the financial services industry prior to determining whether a most-favored-nation exemption would go into effect and whether the U.S. schedule of commitments should be modified.

State Concerns

The last element in the process dealt with issues concerning the 50 states and the District of Columbia of the United States. As extended Uruguay Round negotiations in financial services got under way early in 1995, the U.S. negotiators knew that they would have to seek reservations for a number of existing measures that were not consistent with the GATS's principles of market access, national treatment, or most-favored-nation exemptions. It was easy to list measures on the federal level, but the GATS clearly applied to subnational jurisdictions as well, so inconsistent state measures needed to be listed. The USTR's overall approach to this problem was based on the conclusion that, while some difficulties existed, the United States had a relatively open market in financial services. Since Congress was not going to overrule state banking and securities measures in the context of trade negotiations, the approach was to reserve existing state measures where inconsistencies existed. Treasury and the USTR had conducted a thorough examination of state measures for the financial services chapter of the North American Free Trade Agreement (NAFTA),[16] but the obligations were not the same in the two agreements, so the negotiators could not employ the same exact language.[17] The negotiators drafted a schedule of commitments based on NAFTA and earlier information gathered specifically for the Uruguay Round. Then, they sent this schedule to the state banking and securities regulators of each state and the District of Columbia. (The USTR and Commerce took similar action for the insurance sector.) There were 51 different jurisdictions in all, and at least 2 different regulatory bodies in each jurisdiction. This proved to be a monumental job, because the GATS is a document not easily understood by those unfamiliar with its terms. This lack of familiarity proved a particular problem for state regulators of smaller states, some of whom had never even received an application from a foreign bank to set up business in their state. As a result, some had never had to consider how such a bank would be treated under state law. Of necessity, the USTR had to engage in a lengthy dialogue with the states.

Treasury discovered that many states were revising old laws and, in doing so, were often simplifying, updating, and making it easier for foreign banks to do business. A number of changes were being made to attract out-of-state banks, which included any bank from a different state,

whether it was a foreign bank or another U.S. bank. Other state law changes were impelled by the need to adapt to a new federal law on interstate banking that went into effect in 1995 and enabled all banks, foreign or domestic, to expand into every state through the acquisition of existing banks.[18] (This law represents an instance in which Congress overruled inconsistent state laws in this area.)

Conclusion

The projected end of the extended negotiations in financial services was 1995. The summer of 1995 was the culmination of a long process that revealed a number of lessons for those in the United States engaged in the financial services negotiations. Some lessons that may have relevance beyond the United States should be noted.

First, financial services negotiators should have been involved longer and sooner. For whatever reason—perhaps because of the belief that the idea of including financial services would fade—financial services experts did not become involved until nearly the end of the negotiations. It would have been far better for the financial services experts to have taken action earlier. They did not do that and, as a result, the negotiators were constantly trying to catch up. By the time NAFTA was being negotiated, the lesson had been learned, and financial services experts led the negotiations in their sector from the very beginning.

Second, a certain sequencing of the negotiations arose. At the beginning, the interests of financial services regulators were uppermost, as everyone worked on the text of the agreement. It was crucial to involve the regulators, both for substantive expertise and because it would have been inappropriate to seek congressional approval without addressing the most important concerns of regulators. Later, the attention moved from regulatory concerns to concerns with individual countries and their specific commitments. The input from industry members was then particularly important.

Third, the U.S. negotiators had to take into account the concerns of individual states. Congress had long recognized and accepted the principle of state regulation of banking and securities, and there was not the requisite expertise on the federal level to ensure accurate listing of relevant state reservations. The system for working with the states was imperfect, although Treasury did work quite effectively with associations of state banking and securities regulators that had representative offices in Washington.

Fourth, the process in the United States, although somewhat unwieldy, accomplished quite a lot. The Administration ended up with a position

that was accepted by Congress and the financial services industry, and that kept negotiating options open for further talks. The U.S. negotiators managed to keep in touch with all concerned parties and tried earnestly to accommodate their interests. In addition, most negotiators developed a greater appreciation for the complexities of the U.S. system—the layers of regulation and the relevant actors, both public and private, involved in the process.

Finally, financial service negotiators of all countries, working together, accomplished much. They produced the first significant multilateral agreement across the financial services sector, overcoming a number of obstacles in the process. They won acceptance of the principle that certain characteristics of this highly regulated sector required special provisions and protections. They came up with their own annex and their own prudential carveout. They also were able to have incorporated into the Uruguay Round documents the concept of sectoral committees, and to achieve at the very beginning the establishment of the Committee on Trade in Financial Services to discuss and make recommendations on issues of concern to the sector. While not every goal of every country was achieved, a start was made, and a framework for further negotiations was firmly established. Furthermore, the negotiations are not over yet. It is quite possible that the liberalization a number of countries have undertaken for their own reasons may be available for incorporation into commitments in the GATS when negotiations resume.

Appendix I
International Financial Materials

Appendix I

1 Report of the Executive Board to the Board of Governors on the Proposed Fourth Amendment of the Articles of Agreement of the International Monetary Fund

Part I. Introduction

To enable all members of the Fund to participate in the SDR system, the Interim Committee, in its September 29, 1996 Communiqué, endorsed the Executive Board's proposal that all participants in the Special Drawing Rights Department should receive an equitable share of cumulative SDR allocations through an amendment of the Fund's Articles that would provide for a one-time allocation of SDRs, based on a common benchmark ratio of cumulative allocations to present quotas. The Interim Committee emphasized that such an amendment would not in any way affect the Fund's existing power to allocate SDRs on the basis of a finding of a long-term global need to supplement reserves as and when that need arises.[1]

A proposed amendment that provides for a special one-time allocation to participants ("special allocation") is attached to this Report. Set forth below in Part II of this Report is a Commentary on the proposed amendment. Part III describes the procedures for adoption of this amendment and Part IV contains a draft Resolution.

Part II. Commentary

Section A describes the terms that will govern special allocations made to the various categories of participants under Schedule M of the amendment. General features of the proposed amendment, including the relationship between special allocations and allocations made pursuant to Article XVIII, are described in Section B. The description of the proposed amendment contains references to the relevant paragraphs of Schedule M.

One of the important features of the proposed amendment is its treatment of participants with overdue obligations to the Fund. As is discussed further in Section B, in the event that a participant is in arrears to the

[1]In its April 28, 1997 Communiqué, the Interim Committee welcomed the progress achieved in the Executive Board toward the proposed amendment and requested the Executive Board to finalize its work as soon as possible and to report to the Committee in time for the Hong Kong meeting.

Fund at the time it receives the special allocation, the SDRs allocated to that participant will be deposited and held in an escrow account within the Special Drawing Rights Department and shall be released to the participant upon its discharge of all its overdue obligations to the Fund (paragraph 5). This mechanism would not apply to general allocations made pursuant to Article XVIII.

A. Categories of Recipients

1. Existing Participants

Under the proposed amendment, the amount of SDRs that will be allocated to members that are participants as of September 19, 1997 ("existing participants") will be an amount that will raise their net cumulative allocation-to-quota ratios to a level corresponding to a ratio of 29.315788813 percent (the "benchmark ratio"). As a general rule, this ratio will be applied to existing participants' quotas as of September 19, 1997 (paragraph 1). The application of the benchmark ratio to quotas as of September 19, 1997 has the effect that changes in net cumulative allocations or quotas after September 19, 1997 will not affect the size of the special allocation received by existing participants. As an exception to the above rule, existing participants that have not been able to increase their quotas under the Ninth General Review by September 19, 1997, because they have failed to discharge their overdue obligations to the General Resources Account, will be allocated an amount that is calculated on the basis of their proposed quotas under the Ninth General Review (as set forth in Resolution No. 45-2 of the Board of Governors of the Fund) rather than on the basis of their actual quotas as of September 19, 1997 (paragraph 1). This proposed quota will be used as a basis for calculating the amount of allocation even if the participant never actually increases its quota under the Ninth General Review.

Each existing participant will receive its special allocation on the 30th day following the effective date of the amendment (paragraph 1) unless it has notified the Fund of its desire not to receive the special allocation (paragraph 4).

2. Future Participants

The proposed amendment also makes provision for a special allocation to countries that become participants in the SDR Department after September 19, 1997 but within three months of the date of their membership in the Fund ("future participants") (paragraph 2).

Regarding the method of calculation, the proposed amendment sets forth a formula that attempts to achieve, to the extent possible, comparability of treatment between existing participants and future participants

(paragraph 2(b) and (c)). A future participant will receive a special allocation that will result in its ratio of net cumulative allocation to quota being equal to the benchmark ratio applied to existing participants, as adjusted downwards, in proportion to the change in the total quotas of existing participants that has occurred since September 19, 1997[2] (paragraph 2(b)(i)), and upwards, in proportion to the change in the total net cumulative allocations of existing participants that are attributable to general allocations made after September 19, 1997[3] (paragraph 2(b)(ii)).

Future participants will receive a special allocation on the 30th day following the later of: (i) the date of their participation, or (ii) the effective date of the fourth amendment (paragraph 2(a)), unless they notify the Fund of their desire not to receive the allocation (paragraph 4).

3. The Federal Republic of Yugoslavia (Serbia/Montenegro)

As of September 19, 1997, the Federal Republic of Yugoslavia (Serbia/Montenegro) (the "FRY") has not succeeded to membership in the Fund and participation in the Special Drawing Rights Department in accordance with the terms and conditions of Executive Board Decision No. 10237-(92/150), adopted December 14, 1992, and, therefore, is not an existing participant. Upon satisfying these conditions, it will not be eligible to receive an allocation as a future participant because it will have succeeded retroactively to the former Socialist Federal Republic of Yugoslavia's (the "SFRY") membership in the Fund and participation in the SDR Department, along with the four other successor states of the SFRY. Accordingly, the text of the proposed amendment includes a provision that enables the FRY to receive a special allocation once it becomes a participant (paragraph 3).

With respect to the method of calculation, the proposed amendment provides that the amount to be received will be based on the proposed Ninth Review quota offered to the FRY under paragraph 3(c) of Executive Board Decision No. 10237-(92/150), as adjusted upwards in proportion to the change in the total net cumulative allocations of exist-

[2]Changes arising from: (i) increases in quotas under the Ninth General Review that enter into effect after September 19, 1997, and (ii) the quotas of new participants, will not cause an adjustment (paragraph 2(b)(i) and 2(c), respectively).

[3]The category of existing participants that would be used for purposes of determining the adjustment to be made would be limited to existing participants that have received all allocations made by the Fund since September 19, 1997 (paragraph 2(c)). This would ensure that a future participant would not be adversely affected by a decision taken by an existing participant to opt out of an allocation (which would reduce the amount by which the total of net cumulative allocations of participants would have otherwise increased and, accordingly, would also reduce the extent of the upwards adjustment).

ing participants that are attributable to general allocations made after September 19, 1997 but prior to the date on which the FRY succeeds to membership in the Fund and participation in the Special Drawing Rights Department (paragraph 3(b)). The method of calculating this upward adjustment is the same as that used in the case of future participants.

B. General Features

1. The special allocation to be made pursuant to the proposed amendment will not be made on the basis of a finding of "long-term global need." Rather, the proposed amendment will add a sentence to Article XV to provide for a one-time allocation of SDRs to existing and future participants in accordance with the provisions of Schedule M.

2. The special allocation will not in any way affect the Fund's existing power to allocate SDRs on the basis of a finding of "long-term global need" in accordance with Article XVIII. The text of Article XVIII will not be modified by the amendment. Moreover, a specific reference will be added by the amendment to the first sentence of Article XV for the purpose of emphasizing that allocations made on the basis of "long-term global need" will continue to be made exclusively in accordance with the provisions of Article XVIII.

3. Participants will receive only one allocation under the proposed amendment. Accordingly, the proposed amendment will not establish a permanent mechanism for periodic harmonization of net cumulative allocation-to-quota ratios.

4. Unlike Article XVIII, the special allocation provision will operate without the necessity of a decision by an organ of the Fund; conversely, an organ of the Fund will have no authority to modify the operation of the provision.[4]

5. As noted in the Introduction, SDRs allocated to a participant with overdue obligations to the Fund when the special allocation is made will be deposited in an escrow account within the Special Drawing Rights Department and shall be released to the participant upon discharge of all its overdue obligations to the Fund. The concept of overdue obligations for purposes of this proposed amendment is defined in paragraph 5(c) of Schedule M; it does not include arrears on maintenance of value obligations under Article V, Section 11.

[4] However, the general provisions on the liquidation of the SDR Department will apply: allocations made under the amendment will be suspended if the Executive Board decides that the liquidation of the SDR Department may be necessary and will cease after a decision of the Board of Governors to liquidate the SDR Department or the Fund.

During the period when SDRs are held in an escrow account, these SDRs shall not be available to the participant for any use. Moreover, during this period, the SDRs held in the escrow account would not be included in any calculations of the participant's allocations or holdings of SDRs for the purposes of the Articles other than calculations under Schedule M. Accordingly, they would not be subject to charges or assessments or give rise to payment of interest under Article XX. They would not be taken into consideration for purposes of calculating the extent of the participant's obligations to either reconstitute SDRs (Article XIX, Section 6) or accept SDRs from other participants (Article XIX, Section 4). Since SDRs held in an escrow account would not be available to the participant, they would not be taken into consideration for purposes of calculating a participant's reserves. If SDRs are held in an escrow account when the participant terminates its participation in the Special Drawing Rights Department or when it is decided to liquidate the Special Drawing Rights Department, such SDRs shall be canceled (paragraph 5(b)).

Paragraph 5(d) clarifies that, except for the provisions of that paragraph as described above, the principle of separation between the General Department and the Special Drawing Rights Department and the unconditional character of SDRs as reserve assets shall be maintained.

6. Except for those SDRs that are held in an escrow account pursuant to paragraph 5 of Schedule M, the characteristics of SDRs allocated pursuant to a special allocation will be the same as those of SDRs allocated under Article XVIII.

7. The proposed amendment will also be without prejudice to the application of Article XVIII, Section 2(d), which sets forth the rules regarding the receipt of regular allocations by members that become participants after the commencement of a basic period. Under that provision, the Fund may authorize a new participant to receive regular allocations made during the remainder of the basic period.[5] Accordingly, if a future member becomes a participant during a basic period when allocations are being made, it may be authorized to receive a regular allocation under Article XVIII in addition to its special allocation.

[5]A member that becomes a participant after the commencement of a basic period during which regular allocations are being made may receive such allocations during the remainder of the period only if the Fund so decides. In the past, the Fund has always authorized the receipt of allocations in these cases.

Part III. Procedure

1. The procedure for the adoption of amendments of the Articles of Agreement is set forth in Article XXVIII. Under this Article, a proposed amendment is to be communicated to the Chairman of the Board of Governors for consideration by the Board of Governors. If the proposed amendment is approved by the Board of Governors, the Fund is to ask all members whether they accept it. When three-fifths of the members, having 85 percent of the total voting power, have accepted the proposed amendment, the Fund is to certify that fact by a formal communication to all members. Under Article XXVIII(c), an amendment enters into force for every member, whether or not it has accepted the amendment, three months after that date of that communication unless a shorter period is specified. In the case of the amendment now being proposed, the Executive Board recommends that it should enter into force on the date of the formal communication.

2. Members whose voting rights have been suspended cannot appoint a Governor or Alternate Governor to participate in the vote on the Resolution of the Board of Governors (Schedule L, paragraphs 1(b) and 3(a)). However, since this amendment pertains exclusively to the Special Drawing Rights Department, these members have the right to participate in the acceptance of the proposed amendment under Article XXVIII. Therefore, they shall be counted in the total number of members and included in the calculation of the total voting power for that purpose (Schedule L, paragraphs 1(a) and 2).

Part IV. Resolution

WHEREAS the Interim Committee of the Board of Governors has invited the Executive Board to propose an amendment of the Articles of Agreement of the International Monetary Fund providing for a special one-time allocation of SDRs to allow all participants in the Special Drawing Rights Department to receive an equitable share of cumulative SDR allocations; and

WHEREAS the Executive Board has proposed such an amendment and prepared a report on the same;

NOW, THEREFORE, The Board of Governors, noting the said Report of the Executive Board, hereby RESOLVES that:

1. The proposals for modifications (Proposed Fourth Amendment) that are attached to this Resolution and are to be incorporated in the Articles of Agreement of the International Monetary Fund are approved.

2. The Secretary of the Fund is directed to ask, by circular letter, telegram, or other rapid means of communications, all members of the Fund whether they accept, in accordance with the provisions of Article XXVIII of the Articles, the Proposed Fourth Amendment.

3. The circular letter, telegram, or other communication to be sent to all members in accordance with 2 above shall specify that the Proposed Fourth Amendment shall enter into force for all members as of the date on which the Fund certifies, by formal communication addressed to all members, that three-fifths of the members, having eighty-five percent of the total voting power, have accepted the modifications.

APPENDIX

Proposed Fourth Amendment of the Articles of Agreement of the International Monetary Fund

The Governments on whose behalf the present Agreement is signed agree as follows:

1. The text of Article XV, Section 1 shall be amended to read as follows:

   (a) To meet the need, as and when it arises, for a supplement to existing reserve assets, the Fund is authorized to allocate special drawing rights in accordance with the provisions of Article XVIII to members that are participants in the Special Drawing Rights Department.

   (b) In addition, the Fund shall allocate special drawing rights to members that are participants in the Special Drawing Rights Department in accordance with the provisions of Schedule M.

2. A new Schedule M shall be added to the Articles, to read as follows:

SCHEDULE M

Special One-Time Allocation of Special Drawing Rights

1. Subject to 4 below, each member that, as of September 19, 1997, is a participant in the Special Drawing Rights Department shall, on the 30th day following the effective date of the fourth amendment of this Agreement, receive an allocation of special drawing rights in an amount that will result in its net cumulative allocation of special drawing rights being equal to 29.315788813 percent of its quota as of September 19, 1997, provided that, for participants whose quotas have not been adjusted as proposed in Resolution No. 45-2 of the Board of Governors, calculations shall be made on the basis of the quotas proposed in that resolution.

2. (a) Subject to 4 below, each country that becomes a participant in the Special Drawing Rights Department after September 19, 1997 but within three months of the date of its membership in the Fund shall receive an allocation of special drawing rights in an amount calculated in accordance with (b) and (c) below on the 30th day following the later of: (i) the date on which the new member becomes a participant in the Special Drawing Rights Department, or (ii) the effective date of the fourth amendment of this Agreement.

(b) For the purposes of (a) above, each participant shall receive an amount of special drawing rights that will result in such participant's net cumulative allocation being equal to 29.315788813 percent of its quota as of the date on which the member becomes a participant in the Special Drawing Rights Department, as adjusted:

(i) first, by multiplying 29.315788813 percent by the ratio of the total of quotas, as calculated under 1 above, of the participants described in (c) below to the total of quotas of such participants as of the date on which the member became a participant in the Special Drawing Rights Department, and

(ii) second, by multiplying the product of (i) above by the ratio of the total of the sum of the net cumulative allocations of special drawing rights received under Article XVIII of the participants described in (c) below as of the date on which the member became a participant in the Special Drawing Rights Department and the allocations received by such participants under 1 above to the total of the sum of the net cumulative allocations of special drawing rights received under Article XVIII of such participants as of September 19, 1997 and the allocations received by such participants under 1 above.

(c) For the purposes of the adjustments to be made under (b) above, the participants in the Special Drawing Rights Department shall be members that are participants as of September 19, 1997 and (i) continue to be participants in the Special Drawing Rights Department as of the date on which the member became a participant in the Special Drawing Rights Department, and (ii) have received all allocations made by the Fund after September 19, 1997.

3. (a) Subject to 4 below, if the Federal Republic of Yugoslavia (Serbia/Montenegro) succeeds to the membership in the Fund and the participation in the Special Drawing Rights Department of the former Socialist Federal Republic of Yugoslavia in accordance with the terms and conditions of Executive Board Decision No. 10237-(92/150), adopted December 14, 1992, it shall receive an allocation of special drawing rights

in an amount calculated in accordance with (b) below on the 30th day following the later of: (i) the date on which the Federal Republic of Yugoslavia (Serbia/Montenegro) succeeds to membership in the Fund and participation in the Special Drawing Rights Department in accordance with the terms and conditions of Executive Board Decision No. 10237-(92/150), or (ii) the effective date of the fourth amendment of this Agreement.

(b) For the purposes of (a) above, the Federal Republic of Yugoslavia (Serbia/Montenegro) shall receive an amount of special drawing rights that will result in its net cumulative allocation being equal to 29.315788813 percent of the quota proposed to it under paragraph 3(c) of Executive Board Decision No. 10237-(92/150), as adjusted in accordance with 2(b)(ii) and (c) above as of the date on which the Federal Republic of Yugoslavia (Serbia/Montenegro) qualifies for an allocation under (a) above.

4. The Fund shall not allocate special drawing rights under this Schedule to those participants that have notified the Fund in writing prior to the date of the allocation of their desire not to receive the allocation.

5. (a) If, at the time an allocation is made to a participant under 1, 2, or 3 above, the participant has overdue obligations to the Fund, the special drawing rights so allocated shall be deposited and held in an escrow account within the Special Drawing Rights Department and shall be released to the participant upon discharge of all its overdue obligations to the Fund.

(b) Special drawing rights being held in an escrow account shall not be available for any use and shall not be included in any calculations of allocations or holdings of special drawing rights for the purposes of the Articles, except for calculations under this Schedule. If special drawing rights allocated to a participant are held in an escrow account when the participant terminates its participation in the Special Drawing Rights Department or when it is decided to liquidate the Special Drawing Rights Department, such special drawing rights shall be canceled.

(c) For purposes of this paragraph, overdue obligations to the Fund consist of overdue repurchases and charges in the General Resources Account, overdue principal and interest on loans in the Special Disbursement Account, overdue charges and assessments in the Special Drawing Rights Department, and overdue liabilities to the Fund as trustee.

(d) Except for the provisions of this paragraph, the principle of separation between the General Department and the Special Drawing Rights Department and the unconditional character of special drawing rights as reserve assets shall be maintained.

Appendix II
Payments Materials

Appendix II

1 Convention Providing a Uniform Law for Bills of Exchange and Promissory Notes

Article I [1]

The High Contracting Parties undertake to introduce in their respective territories, either in one of the original texts or in their own languages, the Uniform Law forming Annex I of the present Convention.

This undertaking shall, if necessary, be subject to such reservations as each High Contracting Party shall notify at the time of its ratification or accession. These reservations shall be chosen from among those mentioned in Annex II of the present Convention.

The reservation referred to in Articles 8, 12 and 18 of the said Annex II may, however, be made after ratification or accession, provided that they are notified to the Secretary-General of the League of Nations, who shall forthwith communicate the text thereof to the Members of the League of Nations and to the non-Member States on whose behalf the present Convention has been ratified or acceded to. Such reservations shall not take effect until the ninetieth day following the receipt by the Secretary-General of the above-mentioned notification.

Each of the High Contracting Parties may, in urgent cases, make use of the reservations contained in Articles 7 and 22 of the said Annex II, even after ratification or accession. In such cases they must immediately notify direct all other High Contracting Parties and the Secretary-General of the League of Nations. The notification of these reservations shall take effect two days following its receipt by the High Contracting Parties.

Article II

In the territories of each of the High Contracting Parties the Uniform Law shall not apply to bills of exchange and promissory notes already issued at the time of the coming into force of the present Convention.

Article III

The present Convention, the French and English texts of which shall be equally authentic, shall bear this day's date.

[1]The Convention was signed at Geneva on June 7, 1930 and entered into force on January 1, 1934. 143 League of Nations Treaty Series 259 (1933–34).

It may be signed thereafter until September 6th, 1930, on behalf of any Member of the League of Nations or non-Member State.

Article IV

The present Convention shall be ratified.

The instruments of ratification shall be deposited before September 1st, 1932, with the Secretary-General of the League of Nations, who shall forthwith notify receipt thereof to all the Members of the League of Nations and to the non-Member States Parties to the present Convention.

Article V

As from September 6th, 1930, any Member of the League of Nations and any non-Member State may accede thereto.

Such accession shall be effected by a notification to the Secretary-General of the League of Nations, such notification to be deposited in the archives of the Secretariat.

The Secretary-General shall notify such deposit forthwith to all High Contracting Parties that have signed or acceded to the present Convention.

Article VI

The present Convention shall not come into force until it has been ratified or acceded to on behalf of seven Members of the League of Nations or non-Member States, including therein three of the Members of the League permanently represented on the Council.

The date of entry into force shall be the ninetieth day following the receipt by the Secretary-General of the League of Nations of the seventh ratification or accession in accordance with the first paragraph of the present Article.

The Secretary-General of the League of Nations, when making the notifications provided for in Articles IV and V, shall state in particular that the ratifications or accessions referred to in the first paragraph of the present Article have been received.

Article VII

Every ratification or accession effected after the entry into force of the Convention in accordance with Article VI shall take effect on the ninetieth day following the date of receipt thereof by the Secretary-General of the League of Nations.

Article VIII

Except in urgent cases the present Convention may not be denounced before the expiry of two years from the date on which it has entered into force in respect of the Member of the League or non-Member State denouncing it; such denunciation shall take effect as from the ninetieth day following the receipt by the Secretary-General of the notification addressed to him.

Every denunciation shall be immediately communicated by the Secretary-General of the League of Nations to all the other High Contracting Parties.

In urgent cases a High Contracting Party which denounces the Convention shall immediately notify direct all other High Contracting Parties, and the denunciation shall take effect two days after the receipt of such notification by the said High Contracting Parties. A High Contracting Party denouncing the Convention in these circumstances shall also inform the Secretary-General of the League of Nations of its decision.

Each denunciation shall take effect only as regards the High Contracting Party on whose behalf it has been made.

Article IX

Every Member of the League of Nations and every non-Member State in respect of which the present Convention is in force, may forward to the Secretary-General of the League of Nations, after the expiry of the fourth year following the entry into force of the Convention, a request for the revision of some or all of the provisions of this Convention.

If such request, after being communicated to the other Members or non-Member States between which the Convention is at that time in force, is supported within one year by at least six of them, the Council of the League of Nations shall decide whether a Conference shall be convened for the purpose.

Article X

The High Contracting Parties may declare at the time of signature, ratification or accession that it is not their intention in accepting the present Convention to assume any liability in respect of all or any of their colonies, protectorates or territories under suzerainty or mandate, in which case the present Convention shall not be applicable to the territories mentioned in such declaration.

The High Contracting Parties may at any time subsequently inform the Secretary-General of the League of Nations that they intend to apply the present Convention to all or any of their territories referred to in the declaration provided for in the preceding paragraph. In this case, the Convention shall apply to the territories referred to in the notification ninety days after its receipt by the Secretary-General of the League of Nations.

They further reserve the right to denounce it, in accordance with the conditions of Article VIII, on behalf of all or any of their colonies, protectorates or territories under suzerainty or mandate.

Article XI

The present Convention shall be registered by the Secretary-General of the League of Nations as soon as it comes into force. It shall then be published as soon as possible in the League of Nations *Treaty Series.*

* * *

In faith whereof the above-mentioned Plenipotentiaries have signed the present Convention.

DONE at Geneva, the seventh day of June, one thousand nine hundred and thirty, in a single copy, which shall be deposited in the archives of the Secretariat of the League of Nations, and of which authenticated copies shall be delivered to all Members of the League of Nations and non-Member States represented at the Conference.

ANNEX I

UNIFORM LAW ON BILLS OF EXCHANGE AND PROMISSORY NOTES

TITLE I

BILLS OF EXCHANGE

CHAPTER I. ISSUE AND FORM OF A BILL OF EXCHANGE

Article 1

A bill of exchange contains:

1. The term "bill of exchange" inserted in the body of the instrument and expressed in the language employed in drawing up the instrument;

2. An unconditional order to pay a determinate sum of money;

3. The name of the person who is to pay (drawee);

4. A statement of the time of payment;

5. A statement of the place where payment is to be made;

6. The name of the person to whom or to whose order payment is to be made;

7. A statement of the date and of the place where the bill is issued;

8. The signature of the person who issues the bill (drawer).

Article 2

An instrument in which any of the requirements mentioned in the preceding article is wanting is invalid as a bill of exchange, except in the case specified in the following paragraphs:

A bill of exchange in which the time of payment is not specified is deemed to be payable at sight.

In default of special mention, the place specified beside the name of the drawee is deemed to be the place of payment, and at the same time the place of the domicile of the drawee.

A bill of exchange which does not mention the place of its issue is deemed to have been drawn in the place mentioned beside the name of the drawer.

Article 3

A bill of exchange may be drawn payable to drawer's order.

It may be drawn on the drawer himself.

It may be drawn for account of a third person.

Article 4

A bill of exchange may be payable at the domicile of a third person either in the locality where the drawee has his domicile or in another locality.

Article 5

When a bill of exchange is payable at sight, or at a fixed period after sight, the drawer may stipulate that the sum payable shall bear interest. In the case of any other bill of exchange, this stipulation is deemed not to be written *(non écrite)*.

The rate of interest must be specified in the bill; in default of such specification, the stipulation shall be deemed not to be written *(non écrite)*.

Interest runs from the date of the bill of exchange, unless some other date is specified.

Article 6

When the sum payable by a bill of exchange is expressed in words and also in figures, and there is a discrepancy between the two, the sum denoted by the words is the amount payable.

Where the sum payable by a bill of exchange is expressed more than once in words or more than once in figures, and there is a discrepancy, the smaller sum is the sum payable.

Article 7

If a bill of exchange bears signatures of persons incapable of binding themselves by a bill of exchange, or forged signatures, or signatures of fictitious persons, or signatures which for any other reason cannot bind the persons who signed the bill of exchange or on whose behalf it was signed, the obligations of the other persons who signed it are none the less valid.

Article 8

Whosoever puts his signature on a bill of exchange as representing a person for whom he had no power to act is bound himself as a party to the bill and, if he pays, has the same rights as the person for whom he purported to act. The same rule applies to a representative who has exceeded his powers.

Article 9

The drawer guarantees both acceptance and payment.

He may release himself from guaranteeing acceptance; every stipulation by which he releases himself from the guarantee of payment is deemed not to be written *(non écrite)*.

Article 10

If a bill of exchange, which was incomplete when issued, has been completed otherwise than in accordance with the agreements entered into, the non-observance of such agreements may not be set up against the

holder unless he has acquired the bill of exchange in bad faith or, in acquiring it, has been guilty of gross negligence.

CHAPTER II. ENDORSEMENT

Article 11

Every bill of exchange, even if not expressly drawn to order, may be transferred by means of endorsement.

When the drawer has inserted in a bill of exchange the words "not to order" or an equivalent expression, the instrument can only be transferred according to the form, and with the effects of an ordinary assignment.

The bill may be endorsed even in favour of the drawee, whether he has accepted or not, or of the drawer, or of any other party to the bill. These persons may re-endorse the bill.

Article 12

An endorsement must be unconditional. Any condition to which it is made subject is deemed not to be written *(non écrite)*.

A partial endorsement is null and void.

An endorsement "to bearer" is equivalent to an endorsement in blank.

Article 13

An endorsement must be written on the bill of exchange or on a slip affixed thereto *(allonge)*. It must be signed by the endorser.

The endorsement may leave the beneficiary unspecified or may consist simply of the signature of the endorser (endorsement in blank). In the latter case, the endorsement, to be valid, must be written on the back of the bill of exchange or on the slip attached thereto *(allonge)*.

Article 14

An endorsement transfers all the rights arising out of a bill of exchange.

If the endorsement is in blank, the holder may:

(1) Fill up the blank either with his own name or with the name of some other person;

(2) Re-endorse the bill in blank, or to some other person;

(3) Transfer the bill to a third person without filling up the blank, and without endorsing it.

Article 15

In the absence of any contrary stipulation, the endorser guarantees acceptance and payment.

He may prohibit any further endorsement; in this case, he gives no guarantee to the persons to whom the bill is subsequently endorsed.

Article 16

The possessor of a bill of exchange is deemed to be the lawful holder if he establishes his title to the bill through an uninterrupted series of endorsements, even if the last endorsement is in blank. In this connection, cancelled endorsements are deemed not to be written *(non écrits)*. When an endorsement in blank is followed by another endorsement, the person who signed this last endorsement is deemed to have acquired the bill by the endorsement in blank.

Where a person has been dispossessed of a bill of exchange, in any manner whatsoever, the holder who establishes his right thereto in the manner mentioned in the preceding paragraph is not bound to give up the bill unless he has acquired it in bad faith, or unless in acquiring it he has been guilty of gross negligence.

Article 17

Persons sued on a bill of exchange cannot set up against the holder defences founded on their personal relations with the drawer or with previous holders, unless the holder, in acquiring the bill, has knowingly acted to the detriment of the debtor.

Article 18

When an endorsement contains the statements "value in collection" *("valeur en recouvrement")*, "for collection" *("pour encaissement")*, "by procuration" *("par procuration")* or any other phrase implying a simple mandate, the holder may exercise all rights arising out of the bill of exchange, but he can only endorse it in his capacity as agent.

In this case, the parties liable can only set up against the holder defences which could be set up against the endorser.

The mandate contained in an endorsement by procuration does not terminate by reason of the death of the party giving the mandate or by reason of his becoming legally incapable.

Article 19

When an endorsement contains the statements "value in security" *("valeur en garantie")*, "value in pledge" *("valeur en gage")*, or any other statement implying a pledge, the holder may exercise all the rights arising out of the bill of exchange, but an endorsement by him has the effects only of an endorsement by an agent.

The parties liable cannot set up against the holder defences founded on their personal relations with the endorser, unless the holder, in receiving the bill, has knowingly acted to the detriment of the debtor.

Article 20

An endorsement after maturity has the same effects as an endorsement before maturity. Nevertheless, an endorsement after protest for non-payment, or after the expiration of the limit of time fixed for drawing up the protest, operates only as an ordinary assignment.

Failing proof to the contrary, an endorsement without date is deemed to have been placed on the bill before the expiration of the limit of time fixed for drawing up the protest.

CHAPTER III. ACCEPTANCE

Article 21

Until maturity, a bill of exchange may be presented to the drawee for acceptance at his domicile, either by the holder or by a person who is merely in possession of the bill.

Article 22

In any bill of exchange, the drawer may stipulate that it shall be presented for acceptance with or without fixing a limit of time for presentment.

Except in the case of a bill payable at the address of a third party or in a locality other than that of the domicile of the drawee, or, except in the case of a bill drawn payable at a fixed period after sight, the drawer may prohibit presentment for acceptance.

He may also stipulate that presentment for acceptance shall not take place before a named date.

Unless the drawer has prohibited acceptance, every endorser may stipulate that the bill shall be presented for acceptance, with or without fixing a limit of time for presentment.

Article 23

Bills of exchange payable at a fixed period after sight must be presented for acceptance within one year of their date.

The drawer may abridge or extend this period.

These periods may be abridged by the endorsers.

Article 24

The drawee may demand that a bill shall be presented to him a second time on the day after the first presentment. Parties interested are not allowed to set up that this demand has not been complied with unless this request is mentioned in the protest.

The holder is not obliged to surrender to the drawee a bill presented for acceptance.

Article 25

An acceptance is written on the bill of exchange. It is expressed by the word "accepted" or any other equivalent term. It is signed by the drawee. The simple signature of the drawee on the face of the bill constitutes an acceptance.

When the bill is payable at a certain time after sight, or when it must be presented for acceptance within a certain limit of time in accordance with a special stipulation, the acceptance must be dated as of the day when the acceptance is given, unless the holder requires that it shall be dated as of the day of presentment. If it is undated, the holder, in order to preserve his right of recourse against the endorsers and the drawer, must authenticate the omission by a protest drawn up within the proper time.

Article 26

An acceptance is unconditional, but the drawee may restrict it to part of the sum payable.

Every other modification introduced by an acceptance into the tenor of the bill of exchange operates as a refusal to accept. Nevertheless, the acceptor is bound according to the terms of his acceptance.

Article 27

When the drawer of a bill has indicated a place of payment other than the domicile of the drawee without specifying a third party at

whose address payment must be made, the drawee may name such third party at the time of acceptance. In default of this indication, the acceptor is deemed to have undertaken to pay the bill himself at the place of payment.

If a bill is payable at the domicile of the drawee, the latter may in his acceptance indicate an address in the same place where payment is to be made.

Article 28

By accepting, the drawee undertakes to pay the bill of exchange at its maturity.

In default of payment, the holder, even if he is the drawer, has a direct action on the bill of exchange against the acceptor for all that can be demanded in accordance with Articles 48 and 49.

Article 29

Where the drawee who has put his acceptance on a bill has cancelled it before restoring the bill, acceptance is deemed to be refused. Failing proof to the contrary, the cancellation is deemed to have taken place before the bill was restored.

Nevertheless, if the drawee has notified his acceptance in writing to the holder or to any party who has signed the bill, he is liable to such parties according to the terms of his acceptance.

CHAPTER IV. "AVALS"

Article 30

Payment of a bill of exchange may be guaranteed by an "aval" as to the whole or part of its amount.

This guarantee may be given by a third person or even by a person who has signed as a party to the bill.

Article 31

The "aval" is given either on the bill itself or on an "allonge".

It is expressed by the words "good as aval" *("bon pour aval")* or by any other equivalent formula. It is signed by the giver of the "aval".

It is deemed to be constituted by the mere signature of the giver of the "aval" placed on the face of the bill, except in the case of the signature of the drawee or of the drawer.

An "aval" must specify for whose account it is given. In default of this, it is deemed to be given for the drawer.

Article 32

The giver of an "aval" is bound in the same manner as the person for whom he has become guarantor.

His undertaking is valid even when the liability which he has guaranteed is inoperative for any reason other than defect of form.

He has, when he pays a bill of exchange, the rights arising out of the bill of exchange against the person guaranteed and against those who are liable to the latter on the bill of exchange.

CHAPTER V. MATURITY

Article 33

A bill of exchange may be drawn payable:

At sight;

At a fixed period after sight;

At a fixed period after date;

At a fixed date.

Bills of exchange at other maturities or payable by instalments are null and void.

Article 34

A bill of exchange at sight is payable on presentment. It must be presented for payment within a year of its date. The drawer may abridge or extend this period. These periods may be abridged by the endorsers.

The drawer may prescribe that a bill of exchange payable at sight must not be presented for payment before a named date. In this case, the period for presentment begins from the said date.

Article 35

The maturity of a bill of exchange payable at a fixed period after sight is determined either by the date of the acceptance or by the date of the protest.

In the absence of the protest, an undated acceptance is deemed, so far as regards the acceptor, to have been given on the last day of the limit of time for presentment for acceptance.

Article 36

Where a bill of exchange is drawn at one or more months after date or after sight, the bill matures on the corresponding date of the month when payment must be made. If there be no corresponding date, the bill matures on the last day of this month.

When a bill of exchange is drawn at one or more months and a-half after date or sight, entire months must first be calculated.

If the maturity is fixed at the commencement, in the middle (mid-January or mid-February, etc.) or at the end of the month, the first, fifteenth or last day of the month is to be understood.

The expressions "eight days" or "fifteen days" indicate not one or two weeks, but a period of eight or fifteen actual days.

The expression "half-month" means a period of fifteen days.

Article 37

When a bill of exchange is payable on a fixed day in a place where the calendar is different from the calendar in the place of issue, the day of maturity is deemed to be fixed according to the calendar of the place of payment.

When a bill of exchange drawn between two places having different calendars is payable at a fixed period after date, the day of issue is referred to the corresponding day of the calendar in the place of payment, and the maturity is fixed accordingly.

The time for presenting bills of exchange is calculated in accordance with the rules of the preceding paragraph.

These rules do not apply if a stipulation in the bill or even the simple terms of the instrument indicate an intention to adopt some different rule.

CHAPTER VI. PAYMENT

Article 38

The holder of a bill of exchange payable on a fixed day or at a fixed period after date or after sight must present the bill for payment either on the day on which it is payable or on one of the two business days which follow.

The presentment of a bill of exchange at a clearing-house is equivalent to a presentment for payment.

Article 39

The drawee who pays a bill of exchange may require that it shall be given up to him receipted by the holder.

The holder may not refuse partial payment.

In case of partial payment the drawee may require that mention of this payment shall be made on the bill, and that a receipt therefor shall be given to him.

Article 40

The holder of a bill of exchange cannot be compelled to receive payment thereof before maturity.

The drawee who pays before maturity does so at his own risk and peril.

He who pays at maturity is validly discharged, unless he has been guilty of fraud or gross negligence. He is bound to verify the regularity of the series of endorsements, but not the signature of the endorsers.

Article 41

When a bill of exchange is drawn payable in a currency which is not that of the place of payment, the sum payable may be paid in the currency of the country, according to its value on the date of maturity. If the debtor is in default, the holder may at his option demand that the amount of the bill be paid in the currency of the country according to the rate on the day of maturity or the day of payment.

The usages of the place of payment determine the value of foreign currency. Nevertheless, the drawer may stipulate that the sum payable shall be calculated according to a rate expressed in the bill.

The foregoing rules shall not apply to the case in which the drawer has stipulated that payment must be made in a certain specified currency (stipulation for effective payment in foreign currency).

If the amount of the bill of exchange is specified in a currency having the same denomination, but a different value in the country of issue and the country of payment, reference is deemed to be made to the currency of the place of payment.

Article 42

When a bill of exchange is not presented for payment within the limit of time fixed by Article 38, every debtor is authorised to deposit the amount with the competent authority at the charge, risk and peril of the holder.

CHAPTER VII. RECOURSE FOR NON-ACCEPTANCE OR NON-PAYMENT

Article 43

The holder may exercise his right of recourse against the endorsers, the drawer and the other parties liable:

At maturity:

If payment has not been made;

Even before maturity:

(1) If there has been total or partial refusal to accept;

(2) In the event of the bankruptcy *(faillite)* of the drawee, whether he has accepted or not, or in the event of a stoppage of payment on his part, even when not declared by a judgment, or where execution has been levied against his goods without result;

(3) In the event of the bankruptcy *(faillite)* of the drawer of a non-acceptable bill.

Article 44

Default of acceptance or of payment must be evidenced by an authentic act (protest for non-acceptance or non-payment).

Protest for non-acceptance must be made with the limit of time fixed for presentment for acceptance. If, in the case contemplated by Article 24, paragraph 1, the first presentment takes place on the last day of that time, the protest may nevertheless be drawn up on the next day.

Protest for non-payment of a bill of exchange payable on a fixed day or at a fixed period after date or sight must be made on one of the two business days following the day on which the bill is payable. In the case of a bill payable at sight, the protest must be drawn up under the conditions specified in the foregoing paragraph for the drawing up of a protest for non-acceptance.

Protest for non-acceptance dispenses with presentment for payment and protest for non-payment.

If there is a stoppage of payment on the part of the drawee, whether he has accepted or not, or if execution has been levied against his goods without result, the holder cannot exercise his right of recourse until after presentment of the bill to the drawee for payment and after the protest has been drawn up.

If the drawee, whether he has accepted or not, is declared bankrupt *(faillite déclarée)*, or the event of the declared bankruptcy of the drawer of a non-acceptable bill, the production of the judgment declaring the bankruptcy suffices to enable the holder to exercise his right of recourse.

Article 45

The holder must give notice of non-acceptance or non-payment to his endorser and to the drawer within the four business days which follow the day for protest or, in case of a stipulation *"retour sans frais"*, the day for presentment. Every endorser must, within the two business days following the day on which he receives notice, notify his endorser of the notice he has received, mentioning the names and addresses of those who have given the previous notices, and so on through the series until the drawer is reached. The periods mentioned above run from the receipt of the preceding notice.

When, in conformity with the preceding paragraph, notice is given to a person who has signed a bill of exchange, the same notice must be given within the same limit of time to his *avaliseur*.

Where an endorser either has not specified his address or has specified it in an illegible manner, it is sufficient that notice should be given to the preceding endorser.

A person who must give notice may give it in any form whatever, even by simply returning the bill of exchange.

He must prove that he has given notice within the time allowed. This time-limit shall be regarded as having been observed if a letter giving the notice has been posted within the prescribed time.

A person who does not give notice within the limit of time mentioned above does not forfeit his rights. He is responsible for the injury, if any, caused by his negligence, but the damages shall not exceed the amount of the bill of exchange.

Article 46

The drawer, an endorser, or a person guaranteeing payment by *aval (avaliseur)* may, by the stipulation *"retour sans frais"*, *"sans protêt"*, or any other equivalent expression written on the instrument and signed, release

the holder from having a protest of non-acceptance or non-payment drawn up in order to exercise his right of recourse.

This stipulation does not release the holder from presenting the bill within the prescribed time, or from the notices he has to give. The burden of proving the non-observance of the limits of time lies on the person who seeks to set it up against the holder.

If the stipulation is written by the drawer, it is operative in respect of all persons who have signed the bill; if it is written by an endorser or an *avaliseur,* it is operative only in respect of such endorser or *avaliseur.* If, in spite of the stipulation written by the drawer, the holder has the protest drawn up, he must bear the expenses thereof. When the stipulation emanates from an endorser or *avaliseur,* the cost of the protest, if one is drawn up, may be recovered from all the persons who have signed the bill.

Article 47

All drawers, acceptors, endorsers or guarantors by *aval* of a bill of exchange are jointly and severally liable to the holder.

The holder has the right of proceeding against all these persons individually or collectively without being required to observe the order in which they have become bound.

The same right is possessed by any person signing the bill who has taken it up and paid it.

Proceedings against one of the parties liable do not prevent proceedings against the others, even though they may be subsequent to the party first proceeded against.

Article 48

The holder may recover from the person against whom he exercises his right of recourse:

(1) The amount of the unaccepted or unpaid bill of exchange with interest, if interest has been stipulated for;

(2) Interest at the rate of 6 per cent from the date of maturity;

(3) The expenses of protest and of the notices given as well as other expenses.

If the right of recourse is exercised before maturity, the amount of the bill shall be subject to a discount. This discount shall be calculated according to the official rate of discount (bank-rate) ruling on the date when recourse is exercised at the place of domicile of the holder.

Article 49

A party who takes up and pays a bill of exchange can recover from the parties liable to him:

(1) The entire sum which he has paid;

(2) Interest on the said sum calculated at the rate of 6 per cent, starting from the day when he made payment;

(3) Any expenses which he has incurred.

Article 50

Every party liable against whom a right of recourse is or may be exercised, can require against payment, that the bill shall be given up to him with the protest and a receipted account.

Every endorser who has taken up and paid a bill of exchange may cancel his own endorsement and those of subsequent endorsers.

Article 51

In the case of the exercise of the right of recourse after partial acceptance, the party who pays the sum in respect of which the bill has not been accepted can require that this payment shall be specified on the bill and that he shall be given a receipt therefor. The holder must also give him a certified copy of the bill, together with the protest, in order to enable subsequent recourse to be exercised.

Article 52

Every person having the right of recourse may, in the absence of agreement to the contrary, reimburse himself by means of a fresh bill (redraft) to be drawn at sight on one of the parties liable to him and payable at the domicile of that party.

The redraft includes, in addition to the sums mentioned in Articles 48 and 49, brokerage and the cost of stamping the redraft.

If the redraft is drawn by the holder, the sum payable is fixed according to the rate for a sight bill drawn at the place where the original bill was payable upon the party liable at the place of his domicile. If the redraft is drawn by an endorser, the sum payable is fixed according to the rate for a sight bill drawn at the place where the drawer of the redraft is domiciled upon the place of domicile of the party liable.

Article 53

After the expiration of the limits of time fixed:

For the presentment of a bill of exchange drawn at sight or at a fixed period after sight;

For drawing up the protest for non-acceptance or non-payment;

For presentment for payment in the case of a stipulation *retour sans frais,* the holder loses his rights of recourse against the endorsers, against the drawer and against the other parties liable, with the exception of the acceptor.

In default of presentment for acceptance within the limit of time stipulated by the drawer, the holder loses his right of recourse for non-payment, as well as for non-acceptance, unless it appears from the terms of the stipulation that the drawer only meant to release himself from the guarantee of acceptance.

If the stipulation for a limit of time for presentment is contained in an endorsement, the endorser alone can avail himself of it.

Article 54

Should the presentment of the bill of exchange or the drawing up of the protest within the prescribed limits of time be prevented by an insurmountable obstacle (legal prohibition *(prescription légale)* by any State or other case of *vis major*), these limits of time shall be extended.

The holder is bound to give notice without delay of the case of *vis major* to his endorser and to specify this notice, which he must date and sign, on the bill or on an *allonge*; in other respects the provisions of Article 45 shall apply.

When *vis major* has terminated, the holder must without delay present the bill of exchange for acceptance or payment and, if need be, draw up the protest.

If *vis major* continues to operate beyond thirty days after maturity, recourse may be exercised, and neither presentment nor the drawing up of a protest shall be necessary.

In the case of bills of exchange drawn at sight or at a fixed period after sight, the time-limit of thirty days shall run from the date on which the holder, even before the expiration of the time for presentment, has given notice of *vis major* to his endorser. In the case of bills

of exchange drawn at a certain time after sight, the above time-limit of thirty days shall be added to the period after sight specified in the bill of exchange.

Facts which are purely personal to the holder or to the person whom he has entrusted with the presentment of the bill or drawing up of the protest are not deemed to constitute cases of *vis major*.

CHAPTER VIII. INTERVENTION FOR HONOUR

1. GENERAL PROVISIONS

Article 55

The drawer, an endorser, or a person given an *aval* may specify a person who is to accept or pay in case of need.

A bill of exchange may, subject as hereinafter mentioned, be accepted or paid by a person who intervenes for the honour of any debtor against whom a right of recourse exists.

The person intervening may be a third party, even the drawee, or, save the acceptor, a party already liable on the bill of exchange.

The person intervening is bound to give, within two business days, notice of his intervention to the party for whose honour he has intervened. In default, he is responsible for the injury, if any, due to his negligence, but the damages shall not exceed the amount of the bill of exchange.

2. ACCEPTANCE BY INTERVENTION (FOR HONOUR)

Article 56

There may be acceptance by intervention in all cases where the holder has a right of recourse before maturity on a bill which is capable of acceptance.

When the bill of exchange indicates a person who is designated to accept or pay it in case of need at the place of payment, the holder may not exercise his rights of recourse before maturity against the person naming such referee in case of need and against subsequent signatories, unless he has presented the bill of exchange to the referee in case of need and until, if acceptance is refused by the latter, this refusal has been authenticated by a protest.

In other cases of intervention the holder may refuse an acceptance by intervention. Nevertheless, if he allows it, he loses his right of recourse

before maturity against the person on whose behalf such acceptance was given and against subsequent signatories.

Article 57

Acceptance by intervention is specified on the bill of exchange. It is signed by the person intervening. It mentions the person for whose honour it has been given and, in default of such mention, the acceptance is deemed to have been given for the honour of the drawer.

Article 58

The acceptor by intervention is liable to the holder and to the endorsers, subsequent to the party for whose honour he intervened, in the same manner as such party.

Notwithstanding an acceptance by intervention, the party for whose honour it has been given and the parties liable to him may require the holder, in exchange for payment of the sum mentioned in Article 48, to deliver the bill, the protest, and a receipted account, if any.

3. PAYMENT BY INTERVENTION

Article 59

Payment by intervention may take place in all cases where, either at maturity or before maturity, the holder has a right of recourse on the bill.

Payment must include the whole amount payable by the party for whose honour it is made.

It must be made at the latest on the day following the last day allowed for drawing up the protest for non-payment.

Article 60

If a bill of exchange has been accepted by persons intervening who are domiciled in the place of payment, or if persons domiciled there have been named as referees in case of need, the holder must present the bill to all these persons and, if necessary, have a protest for non-payment drawn up at the latest on the day following the last day allowed for drawing up the protest.

In default of protest within this limit of time, the party who has named the referee in case of need, or for whose account the bill has been accepted, and the subsequent endorsers, are discharged.

Article 61

The holder who refuses payment by intervention loses his right of recourse against any persons who would have been discharged thereby.

Article 62

Payment by intervention must be authenticated by a receipt given on the bill of exchange mentioning the person for whose honour payment has been made. In default of such mention, payment is deemed to have been made for the honour of the drawer.

The bill of exchange and the protest, if any, must be given up to the person paying by intervention.

Article 63

The person paying by intervention acquires the rights arising out of the bill of exchange against the party for whose honour he has paid and against persons who are liable to the latter on the bill of exchange. Nevertheless, he cannot re-endorse the bill of exchange.

Endorsers subsequent to the party for whose honour payment has been made are discharged.

In case of competition for payment by intervention, the payment which effects the greater number of releases has the preference. Any person who, with a knowledge of the facts, intervenes in a manner contrary to this rule, loses his right of recourse against those who would have been discharged.

CHAPTER IX. PARTS OF A SET AND COPIES

1. PARTS OF A SET

Article 64

A bill of exchange can be drawn in a set of two or more identical parts.

These parts must be numbered in the body of the instrument itself; in default, each part is considered as a separate bill of exchange.

Every holder of a bill which does not specify that it has been drawn as a sole bill may, at his own expense, require the delivery of two or more parts. For this purpose he must apply to his immediate endorser, who is bound to assist him in proceeding against his own endorser, and so on in

the series until the drawer is reached. The endorsers are bound to reproduce their endorsements on the new parts of the set.

Article 65

Payment made on one part of a set operates as a discharge, even though there is no stipulation that this payment annuls the effect of the other parts. Nevertheless, the drawee is liable on each accepted part which he has not recovered.

An endorser who has transferred parts of a set to different persons, as well as subsequent endorsers, are liable on all the parts bearing their signature which have not been restored.

Article 66

A party who has sent one part for acceptance must indicate on the other parts the name of the person in whose hands this part is to be found. That person is bound to give it up to the lawful holder of another part.

If he refuses, the holder cannot exercise his right of recourse until he has had a protest drawn up specifying:

(1) That the part sent for acceptance has not been given up to him on his demand;

(2) That acceptance or payment could not be obtained on another of the parts.

2. COPIES

Article 67

Every holder of a bill of exchange has the right to make copies of it.

A copy must reproduce the original exactly, with the endorsements and all other statements to be found therein. It must specify where the copy ends.

It may be endorsed and guaranteed by *aval* in the same manner and with the same effects as the original.

Article 68

A copy must specify the person in possession of the original instrument. The latter is bound to hand over the said instrument to the lawful holder of the copy.

If he refuses, the holder may not exercise his right of recourse against the persons who have endorsed the copy or guaranteed it by *aval* until he has had a protest drawn up specifying that the original has not been given up to him on his demand.

Where the original instrument, after the last endorsement before the making of the copy contains a clause "commencing from here an endorsement is only valid if made on the copy" or some equivalent formula, a subsequent endorsement on the original is null and void.

CHAPTER X. ALTERATIONS

Article 69

In case of alteration of the text of a bill of exchange, parties who have signed subsequent to the alteration are bound according to the terms of the altered text; parties who have signed before the alteration are bound according to the terms of the original text.

CHAPTER XI. LIMITATION OF ACTIONS

Article 70

All actions arising out of a bill of exchange against the acceptor are barred after three years, reckoned from the date of maturity.

Actions by the holder against the endorsers and against the drawer are barred after one year from the date of a protest drawn up within proper time, or from the date of maturity where there is a stipulation *retour sans frais.*

Actions by endorsers against each other and against the drawer are barred after six months, reckoned from the day when the endorser took up and paid the bill or from the day when he himself was sued.

Article 71

Interruption of the period of limitation is only effective against the person in respect of whom the period has been interrupted.

CHAPTER XII. GENERAL PROVISIONS

Article 72

Payment of a bill of exchange which falls due on a legal holiday *(jour férié légal)* cannot be demanded until the next business day. So, too, all

other proceedings relating to a bill of exchange, in particular presentment for acceptance and protest, can only be taken on a business day.

Where any of these proceedings must be taken within a certain limit of time the last day of which is a legal holiday *(jour férié légal),* the limit of time is extended until the first business day which follows the expiration of that time. Intermediate holidays *(jours fériés)* are included in computing limits of time.

Article 73

Legal or contractual limits of time do not include the day on which the period commences.

Article 74

No days of grace, whether legal or judicial, are permitted.

TITLE II

PROMISSORY NOTES

Article 75

A promissory note contains:

(1) The term "promissory note" inserted in the body of the instrument and expressed in the language employed in drawing up the instrument;

(2) An unconditional promise to pay a determinate sum of money;

(3) A statement of the time of payment;

(4) A statement of the place where payment is to be made;

(5) The name of the person to whom or to whose order payment is to be made;

(6) A statement of the date and of the place where the promissory note is issued;

(7) The signature of the person who issues the instrument (maker).

Article 76

An instrument in which any of the requirements mentioned in the preceding article are wanting is invalid as a promissory note except in the cases specified in the following paragraphs:

A promissory note in which the time of payment is not specified is deemed to be payable at sight.

In default of special mention, the place where the instrument is made is deemed to be the place of payment and at the same time the place of the domicile of the maker.

A promissory note which does not mention the place of its issue is deemed to have been made in the place mentioned beside the name of the maker.

Article 77

The following provisions relating to bills of exchange apply to promissory notes so far as they are not inconsistent with the nature of these instruments, viz.:

Endorsement (Articles 11 to 20);

Time of payment (Articles 33 to 37);

Payment (Articles 38 to 42);

Recourse in case of non-payment (Articles 43 to 50, 52 to 54);

Payment by intervention (Articles 55, 59 to 63);

Copies (Articles 67 and 68);

Alterations (Article 69);

Limitation of actions (Articles 70 and 71);

Holidays, computation of limits of time and prohibition of days of grace (Articles 72, 73, and 74).

The following provisions are also applicable to a promissory note: The provisions concerning a bill of exchange payable at the address of a third party or in a locality other than that of the domicile of the drawee (Articles 4 and 27); stipulation for interest (Article 5); discrepancies as regards the sum payable (Article 6); the consequences of signature under the conditions mentioned in Article 7, the consequences of signature by a person who acts without authority or who exceeds his authority (Article 8); and provisions concerning a bill of exchange in blank (Article 10).

The following provisions are also applicable to a promissory note: Provisions relating to guarantee by *aval* (Articles 30–32); in the case provided for in Article 31, last paragraph, if the *aval* does not specify on whose behalf it has been given, it is deemed to have been given on behalf of the maker of the promissory note.

Article 78

The maker of a promissory note is bound in the same manner as an acceptor of a bill of exchange.

Promissory notes payable at a certain time after sight must be presented for the visa of the maker within the limits of time fixed by Article 23. The limit of time runs from the date of the visa signed by the maker on the note. The refusal of the maker to give his visa with the date thereon must be authenticated by a protest (Article 25), the date of which marks the commencement of the period of time after sight.

ANNEX II

Article 1

Each of the High Contracting Parties may stipulate that the obligation to insert in bills of exchange issued in its territory the term "bill of exchange", as laid down in Article 1, 1 of the Uniform Law, shall not apply until six months after the entry into force of the present Convention.

Article 2

Each of the High Contracting Parties has, as regards undertakings entered into in respect of bills of exchange in its own territory, the right to determine in what manner an actual signature may be replaced by an authentic declaration written on the bill which evidences the consent of the party who should have signed.

Article 3

Each of the High Contracting Parties reserves the right not to embody Article 10 of the Uniform Law in its national law.

Article 4

By way of derogation from Article 31, paragraph 1, of the Uniform Law, each of the High Contracting Parties shall have the right to decide that an *aval* may be given in its territory by a separate instrument specifying the place in which the instrument has been executed.

Article 5

Each of the High Contracting Parties may supplement Article 38 of the Uniform Law so as to provide that the holder of a bill of exchange

payable in its territory shall be obliged to present it on the actual day of maturity. Failure to comply with this obligation may only give rise to a right to damages.

The other High Contracting Parties shall have the right to determine the conditions subject to which such obligation will be recognised by them.

Article 6

For the purpose of giving effect to the last paragraph of Article 38 of the Uniform Law, each of the High Contracting Parties shall determine the institutions which, according to its national law, are to be regarded as clearing-houses.

Article 7

Each of the High Contracting Parties shall have the right, if it deems fit, in exceptional circumstances connected with the rate of exchange in such State, to derogate from the stipulation contained in Article 41 for effective payment in foreign currency as regards bills of exchange payable in its territory. The above rule may also be applied as regards the issue in the national territory of bills of exchange payable in foreign currencies.

Article 8

Each of the High Contracting Parties may prescribe that protest to be drawn up in its territory may be replaced by a declaration dated and written on the bill itself, and signed by the drawee, except where the drawer stipulates in the body of the bill of exchange itself for an authenticated protest.

Each of the High Contracting Parties may also prescribe that the said declaration shall be inscribed in a public register within the limit of time fixed for protests.

In the case provided for in the preceding paragraphs, an undated endorsement is presumed to have been made prior to the protest.

Article 9

By way of derogation from Article 44, paragraph 3, of the Uniform Law, each of the High Contracting Parties has the right to prescribe that a protest for non-payment must be drawn up either on the day when the bill is payable or on one of the two following business days.

Article 10

It is reserved to the legislation of each of the High Contracting Parties to determine the exact legal situations referred to in Article 43, Nos. 2 and 3, and in Article 44, paragraphs 5 and 6, of the Uniform Law.

Article 11

By way of derogation from the provisions of Article 43, Nos. 2 and 3, and Article 74 of the Uniform Law, each of the High Contracting Parties reserves the right to include in its legislation the possibility for persons guaranteeing a bill of exchange to obtain, in the event of recourse being exercised against them, periods of grace which may in no case extend beyond the maturity of the bill.

Article 12

By way of derogation from Article 45 of the Uniform Law, each of the High Contracting Parties shall be entitled to maintain or introduce the following system of notification by the public official, viz., that, when protesting for non-acceptance or non-payment, the notary or official who, under the national law, is authorised to draw up the protest, is required to give notice in writing to the persons liable under the bill of exchange whose addresses are specified in the bills or are known to the public official drawing up the protest, or are specified by the persons demanding the protest. The costs of such notice shall be added to the costs of the protest.

Article 13

Each of the High Contracting Parties is entitled to prescribe, as regards bills of exchange which are both issued and payable in its territory, that the rate of interest mentioned in Article 48, No. 2, and Article 49, No. 2, of the Uniform Law be replaced by the legal rate in force in the territory of that High Contracting Party.

Article 14

By derogation from Article 48 of the Uniform Law each of the High Contracting Parties reserves the right to insert in its national law a rule prescribing that the holder may claim from the party against whom he is exercising his right of recourse a commission the amount of which shall be determined by the national law.

The same applies, by derogation from Article 49 of the Uniform Law, to a person who, having taken up and paid the bill of exchange, claims the amount from the parties liable to him.

Article 15

Each of the High Contracting Parties is free to decide that, in the event of extinctive prescription *(déchéance)* or limitation of actions *(prescription)*, proceedings may be taken in its territory against a drawer who has not provided cover *(provision)* for the bill, or against a drawer or endorser who has made an inequitable gain. The same right exists in the case of limitation of action as regards an acceptor who has received cover or made an inequitable gain *(se serait enrichi injustement)*.

Article 16

The question whether the drawer is obliged to provide cover *(provision)* at maturity and whether the holder has special rights to this cover remains outside the scope of the Uniform Law.

The same applies to any other question concerning the legal relations on the basis of which the bill was issued.

Article 17

It is for the legislation of each of the High Contracting Parties to determine the causes of interruption or suspension of limitation *(prescription)* in the case of actions on bills of exchange which come before its courts.

The other High Contracting Parties are entitled to determine the conditions subject to which they will recognise such causes. The same applies to the effect of an action as a means of indicating the commencement of the period of limitation *(prescription)* laid down in Article 70, paragraph 3, of the Uniform Law.

Article 18

Each of the High Contracting Parties has the right to prescribe that certain business days shall be assimilated to legal holidays *(jours fériés légaux)* as regards presentment for acceptance or payment and all other acts relating to bills of exchange.

Article 19

Each of the High Contracting Parties may determine the denomination to be adopted in the national laws for the instruments referred to in

Article 75 of the Uniform Law, or may exempt them from any special denomination, provided that they contain an express mention that they are drawn to order.

Article 20

The provisions of Articles 1 to 18 of the present Annex with regard to bills of exchange apply likewise to promissory notes.

Article 21

Each of the High Contracting Parties reserves the right to restrict the undertaking mentioned in Article 1 of the Convention to the provisions dealing with bills of exchange only, and not to introduce into its territory the provisions dealing with promissory notes contained in Title II of the Uniform Law. In this case the High Contracting Party making use of this reservation shall only be regarded as a contracting party in respect of bills of exchange.

Each of the High Contracting Parties further reserves the right to embody the provisions concerning promissory notes in a special regulation, which shall exactly conform to the stipulations in Title II of the Uniform Law and which shall reproduce the rules on bills of exchange to which reference is made, subject only to the modifications resulting from Articles 75, 76, 77 and 78 of the Uniform Law and from Articles 19 and 20 of the present Annex.

Article 22

Each of the High Contracting Parties has the right to adopt exceptional measures of a general nature relating to the extension of the limits of time for conservatory measures in relation to recourse *(actes conservatoires des recours)* and to the extension of maturities.

Article 23

Each of the High Contracting Parties undertakes to recognise the provisions adopted by every other High Contracting Party in virtue of Articles 1 to 4, 6, 8 to 16 and 18 to 21 of the present Annex.

Appendix II

2 Convention Providing a Uniform Law for Cheques

Article I [1]

The High Contracting Parties undertake to introduce in their respective territories, either in one of the original texts or in their own languages, the Uniform Law forming Annex I of the present Convention.

This undertaking shall, if necessary, be subject to such reservations as each High Contracting Party shall notify at the time of its ratification or accession. These reservations shall be chosen from among those mentioned in Annex II of the present Convention.

The reservations referred to in Articles 9, 22, 27 and 30 of the said Annex II may, however, be made after ratification or accession, provided that they are notified to the Secretary-General of the League of Nations, who shall forthwith communicate the text thereof to the Members of the League of Nations and to the non-member States on whose behalf the present Convention has been ratified or acceded to. Such reservations shall not take effect until the ninetieth day following the receipt by the Secretary-General of the above-mentioned notification.

Each of the High Contracting Parties may, in urgent cases, make use of the reservations contained in Articles 17 and 28 of the said Annex II, even after ratification or accession. In such cases, they must immediately notify direct all other High Contracting Parties and the Secretary-General of the League of Nations. The notification of these reservations shall take effect two days following its receipt by the High Contracting Parties.

Article II

In the territories of each of the High Contracting Parties, the Uniform Law shall not apply to cheques already issued at the time of the coming into force of the present Convention.

Article III

The present Convention, the French and English texts of which shall be equally authentic, shall bear this day's date.

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[1]The Convention was signed at Geneva on March 19, 1931 and entered into force on January 1, 1934. 143 League of Nations Treaty Series 357 (1933–34).

It may be signed thereafter until July 15th, 1931, on behalf of any Member of the League of Nations or non-member State.

Article IV

The present Convention shall be ratified.

The instruments of ratification shall be deposited before September 1, 1933, with the Secretary-General of the League of Nations, who shall forthwith notify receipt thereof to all the Members of the League of Nations and to the non-member States on whose behalf the present Convention has been signed or acceded to.

Article V

As from July 15, 1931, any Member of the League of Nations and any non-member State may accede thereto.

Such accession shall be effected by a notification to the Secretary-General of the League of Nations, such notification to be deposited in the archives of the Secretariat.

The Secretary-General shall notify such deposit forthwith to all the Members of the League of Nations and to the non-member States on whose behalf the present Convention has been signed or acceded to.

Article VI

The present Convention shall not come into force until it has been ratified or acceded to on behalf of seven Members of the League of Nations or non-member States, including therein three of the Members of the League permanently represented on the Council.

The date of entry into force shall be the ninetieth day following the receipt by the Secretary-General of the League of Nations of the seventh ratification or accession in accordance with the first paragraph of the present Article.

The Secretary-General of the League of Nations, when making the notifications provided for in Articles IV and V, shall state in particular that the ratifications or accessions referred to in the first paragraph of the present Article have been received.

Article VII

Every ratification or accession effected after the entry into force of the Convention in accordance with Article VI shall take effect on the ninetieth day following the date of receipt thereof by the Secretary-General of the League of Nations.

Article VIII

Except in urgent cases, the present Convention may not be denounced before the expiry of two years from the date on which it has entered into force in respect of the Member of the League or non-member State denouncing it; such denunciation shall take effect as from the ninetieth day following the receipt by the Secretary-General of the notification addressed to him.

Every denunciation shall be immediately communicated by the Secretary-General of the League of Nations to all the other High Contracting Parties.

In urgent cases a High Contracting Party which denounces the Convention shall immediately notify direct all other High Contracting Parties, and the denunciation shall take effect two days after the receipt of such notification by the said High Contracting Parties. A High Contracting Party denouncing the Convention in these circumstances shall also inform the Secretary-General of the League of Nations of its decision.

Each denunciation shall take effect only as regards the High Contracting Party on whose behalf it has been made.

Article IX

Every Member of the League of Nations and every non-member State in respect of which the present Convention is in force may forward to the Secretary-General of the League of Nations, after the expiry of the fourth year following the entry into force of the Convention, a request for the revision of some or all of the provisions of this Convention.

If such request, after being communicated to the other Members or non-member States between which the Convention is at that time in force, is supported within one year by at least six of them, the Council of the League of Nations shall decide whether a Conference shall be convened for the purpose.

Article X

The High Contracting Parties may declare at the time of signature, ratification or accession, that it is not their intention in accepting the present Convention to assume any liability in respect of all or any of their colonies, protectorates or territories under suzerainty or mandate, in which case the present Convention shall not be applicable to the territories mentioned in such declaration.

The High Contracting Parties may any time subsequently inform the Secretary-General of the League of Nations that they intend to apply the

present Convention to all or any of their territories referred to in the declaration provided for in the preceding paragraph. In this case, the Convention shall apply to the territories referred to in the notification ninety days after its receipt by the Secretary-General of the League of Nations.

They further reserve the right to denounce it, in accordance with the conditions of Article VIII, on behalf of all or any of their colonies, protectorates or territories under suzerainty or mandate.

Article XI

The present Convention shall be registered by the Secretary-General of the League of Nations as soon as it comes into force.

* * *

In faith whereof the above-mentioned Plenipotentiaries have signed the present Convention.

DONE at Geneva, the nineteenth day of March, one thousand nine hundred and thirty-one, in a single copy, which shall be deposited in the archives of the Secretariat of the League of Nations, and of which authenticated copies shall be delivered to all Members of the League of Nations and non-member States represented at the Conference.

ANNEX I

UNIFORM LAW ON CHEQUES

CHAPTER I. THE DRAWING AND FORM OF A CHEQUE

Article 1

A cheque contains:

1. The term "cheque" inserted in the body of the instrument and expressed in the language employed in drawing up the instrument;
2. An unconditional order to pay a determinate sum of money;
3. The name of the person who is to pay (drawee);
4. A statement of the place where payment is to be made;
5. A statement of the date when and the place where the cheque is drawn;
6. The signature of the person who draws the cheque (drawer).

Article 2

An instrument in which any of the requirements mentioned in the preceding article is wanting is invalid as a cheque, except in the cases specified in the following paragraphs:

In the absence of special mention, the place specified beside the name of the drawee is deemed to be the place of payment. If several places are named beside the name of the drawee, the cheque is payable at the first place named.

In the absence of these statements, and of any other indication, the cheque is payable at the place where the drawee has his principal establishment.

A cheque which does not specify the place at which it was drawn is deemed to have been drawn in the place specified beside the name of the drawer.

Article 3

A cheque must be drawn on a banker holding funds at the disposal of the drawer and in conformity with an agreement, express or implied, whereby the drawer is entitled to dispose of those funds by cheque. Nevertheless, if these provisions are not complied with, the instrument is still valid as a cheque.

Article 4

A cheque cannot be accepted. A statement of acceptance on a cheque shall be disregarded.

Article 5

A cheque may be made payable:

To a specified person with or without the express clause "to order", or

To a specified person, with the words "not to order" or equivalent words, or

To bearer.

A cheque made payable to a specified person with the words "or to bearer", or any equivalent words, is deemed to be a cheque to bearer.

A cheque which does not specify the payee is deemed to be a cheque to bearer.

Article 6

A cheque may be drawn to the drawer's own order.

A cheque may be drawn for account of a third person.

A cheque may not be drawn on the drawer himself unless it is drawn by one establishment on another establishment belonging to the same drawer.

Article 7

Any stipulation concerning interest which may be embodied in the cheque shall be disregarded.

Article 8

A cheque may be payable at the domicile of a third person either in the locality where the drawee has his domicile or in another locality, provided always that such third person is a banker.

Article 9

Where the sum payable by a cheque is expressed in words and also in figures, and there is any discrepancy, the sum denoted by the words is the amount payable.

Where the sum payable by a cheque is expressed more than once in words or more than once in figures, and there is any discrepancy, the smaller sum is the sum payable.

Article 10

If a cheque bears signatures of persons incapable of binding themselves by a cheque, or forged signatures, or signatures of fictitious persons, or signatures which for any other reason cannot bind the persons who signed the cheque or on whose behalf it was signed, the obligations of the other persons who have signed it are none the less valid.

Article 11

Whosoever puts his signature on a cheque as representing a person for whom he had no power to act is bound himself as a party to the cheque and, if he pays, has the same rights as the person for whom he purported to act. The same rule applies to a representative who has exceeded his powers.

Article 12

The drawer guarantees payment. Any stipulation by which the drawer releases himself from this guarantee shall be disregarded.

Article 13

If a cheque which was incomplete when issued has been completed otherwise than in accordance with the agreements entered into, the non-observance of such agreements may not be set up against the holder unless he has acquired the cheque in bad faith or, in acquiring it, has been guilty of gross negligence.

CHAPTER II. NEGOTIATION

Article 14

A cheque made payable to a specified person, with or without the express clause "to order", may be transferred by means of endorsement.

A cheque made payable to a specified person, in which the words "not to order" or any equivalent expression have been inserted, can only be transferred according to the form and with the effects of an ordinary assignment.

A cheque may be endorsed even to the drawer or to any other party to the cheque. These persons may re-endorse the cheque.

Article 15

An endorsement must be unconditional. Any condition to which it is made subject shall be disregarded.

A partial endorsement is null and void.

An endorsement by the drawee is also null and void.

An endorsement "to bearer" is equivalent to an endorsement in blank.

An endorsement to the drawee has the effect only of a receipt, except in the case where the drawee has several establishments and the endorsement is made in favour of an establishment other than that on which the cheque has been drawn.

Article 16

An endorsement must be written on the cheque or on a slip affixed thereto (*allonge*). It must be signed by the endorser.

The endorsement may leave the beneficiary unspecified or may consist simply of the signature of the endorser (endorsement in blank). In the latter case, the endorsement, to be valid, must be written on the back of the cheque or on the slip attached thereto (*allonge*).

Article 17

An endorsement transfers all the rights arising out of a cheque.

If the endorsement is in blank, the holder may:

(1) Fill up the blank either with his own name or with the name of some other person;

(2) Re-endorse the cheque in blank or to some other person;

(3) Transfer the cheque to a third person without filling up the blank and without endorsing it.

Article 18

In the absence of any contrary stipulation, the endorser guarantees payment.

He may prohibit any further endorsement; in this case he gives no guarantee to the persons to whom the cheque is subsequently endorsed.

Article 19

The possessor of an endorsable cheque is deemed to be the lawful holder if he establishes his title to the cheque through an uninterrupted series of endorsements, even if the last endorsement is in blank. In this connection, cancelled endorsements shall be disregarded. When an endorsement in blank is followed by another endorsement, the person who signed this last endorsement is deemed to have acquired the cheque by the endorsement in blank.

Article 20

An endorsement on a cheque to bearer renders the endorser liable in accordance with the provisions governing the right of recourse; but it does not convert the instrument into a cheque to order.

Article 21

Where a person has, in any manner whatsoever, been dispossessed of a cheque (whether it is a cheque to bearer or an endorsable cheque to

which the holder establishes his right in the manner mentioned in Article 19), the holder into whose possession the cheque has come is not bound to give up the cheque unless he has acquired it in bad faith or unless in acquiring it he has been guilty of gross negligence.

Article 22

Persons sued on a cheque cannot set up against the holder defences founded on their personal relations with the drawer or with previous holders, unless the holder in acquiring the cheque has knowingly acted to the detriment of the debtor.

Article 23

When an endorsement contains the statement "value in collection" *("valeur en recouvrement")*, "for collection" *("pour encaissement")*, "by procuration" *("par procuration")*, or any other phrase implying a simple mandate, the holder may exercise all rights arising out of the cheque, but he can endorse it only in his capacity as agent.

In this case the parties liable can only set up against the holder defences which could be set up against the endorser.

The mandate contained in an endorsement by procuration does not terminate by reason of the death of the party giving the mandate or by reason of his becoming legally incapable.

Article 24

An endorsement after protest or after an equivalent declaration or after the expiration of the limit of time for presentment operates only as an ordinary assignment.

Failing proof to the contrary, an undated endorsement is deemed to have been placed on the cheque prior to the protest or equivalent declaration or prior to the expiration of the limit of time referred to in the preceding paragraph.

CHAPTER III. "AVALS"

Article 25

Payment of a cheque may be guaranteed by an "aval" as to the whole or part of its amount.

This guarantee may be given by a third person other than the drawee, or even by a person who has signed the cheque.

Article 26

An "aval" is given either on the cheque itself or on an "allonge".

It is expressed by the words "good as aval", or by any other equivalent formula. It is signed by the giver of the "aval".

It is deemed to be constituted by the mere signature of the giver of the "aval", placed on the face of the cheque, except in the case of the signature of the drawer.

An "aval" must specify for whose account it is given. In default of this, it is deemed to be given for the drawer.

Article 27

The giver of an "aval" is bound in the same manner as the person for whom he has become guarantor.

His undertaking is valid even when the liability which he has guaranteed is inoperative for any reason other than defect of form.

He has, when he pays the cheque, the rights arising out of the cheque against the person guaranteed and against those who are liable to the latter on the cheque.

CHAPTER IV. PRESENTMENT AND PAYMENT

Article 28

A cheque is payable at sight. Any contrary stipulation shall be disregarded.

A cheque presented for payment before the date stated as the date of issue is payable on the day of presentment.

Article 29

A cheque payable in the country in which it was issued must be presented for payment within eight days.

A cheque issued in a country other than in which it is payable must be presented within a period of twenty days or of seventy days, according as to whether the place of issue and the place of payment are situated respectively in the same continent or in different continents.

For the purposes of this article cheques issued in a European country and payable in a country bordering on the Mediterranean or *vice versa* are regarded as issued and payable in the same continent.

The date from which the above-mentioned periods of time shall begin to run shall be the date stated on the cheque as the date of issue.

Article 30

Where a cheque is drawn in one place and is payable in another having a different calendar, the day of issue shall be construed as being the corresponding day of the calendar of the place of payment.

Article 31

Presentment of a cheque at a clearing-house is equivalent to presentment for payment.

Article 32

The countermand of a cheque only takes effect after the expiration of the limit of time for presentment.

If a cheque has not been countermanded, the drawee may pay it even after the expiration of the time-limit.

Article 33

Neither the death of the drawer nor his incapacity taking place after the issue of the cheque shall have any effect as regards the cheque.

Article 34

The drawee who pays a cheque may require that it shall be given up to him receipted by the holder.

The holder may not refuse partial payment.

In case of partial payment the drawee may require that the partial payment shall be mentioned on the cheque and that a receipt shall be given to him.

Article 35

The drawee who pays an endorsable cheque is bound to verify the regularity of the series of endorsements, but not the signature of the endorsers.

Article 36

When a cheque is drawn payable in a currency which is not that of the place of payment, the sum payable may, within the limit of time for the presentment of the cheque, be paid in the currency of the country according to its value on the date of payment. If payment has not been made on presentment, the holder may at his option demand that payment of the amount of the cheque in the currency of the country shall be made according to the rate on the day of presentment or on the day of payment.

The usages of the place of payment shall be applied in determining the value of foreign currency. Nevertheless, the drawer may stipulate that the sum payable shall be calculated according to a rate expressed in the cheque.

The foregoing rules shall not apply to the case in which the drawer has stipulated that payment must be made in a certain specified currency (stipulation for effective payment in a foreign currency).

If the amount of the cheque is specified in a currency having the same denomination but a different value in the country of issue and the country of payment, reference is deemed to be made to the currency of the place of payment.

CHAPTER V. CROSSED CHEQUES AND CHEQUES PAYABLE IN ACCOUNT

Article 37

The drawer or holder of a cheque may cross it with the effects stated in the next article hereof.

A crossing takes the form of two parallel lines drawn on the face of the cheque. The crossing may be general or special.

The crossing is general if it consists of the two lines only or if between the lines the term "banker" or some equivalent is inserted; it is special if the name of a banker is written between the lines.

A general crossing may be converted into a special crossing, but a special crossing may not be converted into a general crossing.

The obliteration either of a crossing or of the name of the banker shall be regarded as not having taken place.

Article 38

A cheque which is crossed generally can be paid by the drawee only to a banker or to a customer of the drawee.

A cheque which is crossed specially can be paid by the drawee only to the named banker, or if the latter is the drawee, to his customer. Nevertheless, the named banker may procure the cheque to be collected by another banker.

A banker may not acquire a crossed cheque except from one of his customers or from another banker. He may not collect it for the account of other persons than the foregoing.

A cheque bearing several special crossings may not be paid by the drawee except in a case where there are two crossings, one of which is for collection through a clearing-house.

The drawee or banker who fails to observe the above provisions is liable for resulting damage up to the amount of the cheque.

Article 39

The drawer or the holder of a cheque may forbid its payment in cash by writing transversally across the face of the cheque the words "payable in account" *("à porter en compte")* or a similar expression.

In such a case the cheque can only be settled by the drawee by means of book-entry (credit in account, transfer from one account to another, set off or clearing-house settlement). Settlement by book-entry is equivalent to payment.

Any obliteration of the words "payable in account" shall be deemed not to have taken place.

The drawee who does not observe the foregoing provisions is liable for resulting damage up to the amount of the cheque.

CHAPTER VI. RECOURSE FOR NON-PAYMENT

Article 40

The holder may exercise his right of recourse against the endorsers, the drawer and the other parties liable if the cheque on presentment in due time is not paid, and if the refusal to pay is evidenced:

(1) By a formal instrument (protest), or

(2) By a declaration dated and written by the drawee on the cheque and specifying the day of presentment, or

(3) By a dated declaration made by a clearing-house, stating that the cheque has been delivered in due time and has not been paid.

Article 41

The protest or equivalent declaration must be made before the expiration of the limit of time for presentment.

If the cheque is presented on the last day of the limit of time, the protest may be drawn up or the equivalent declaration made on the first business day following.

Article 42

The holder must give notice of non-payment to his endorser and to the drawer within the four business days which follow the day on which the protest is drawn up or the equivalent declaration is made or, in case of a stipulation *(retour sans frais),* the day of presentment. Every endorser must, within the two business days following the day on which he receives notice, inform his endorser of the notice which he has received, mentioning the names and addresses of those who have given the previous notices and so on through the series until the drawer is reached. The periods mentioned above run from the receipt of the preceding notice.

When, in conformity with the preceding paragraph, notice is given to a person who has signed a cheque, the same notice must be given within the same limit of time to his *avaliseur.*

Where an endorser either has not specified his address or has specified it in an illegible manner, it is sufficient if notice is given to the endorser preceding him.

The person who must give notice may give it in any form whatever, even by simply returning the cheque.

He must prove that he has given notice within the limit of time prescribed. This time-limit shall be regarded as having been observed if a letter giving the notice has been posted within the said time.

A person who does not give notice within the limit of time prescribed above does not forfeit his rights. He is liable for the damage, if any, caused by his negligence, but the amount of his liability shall not exceed the amount of the cheque.

Article 43

The drawer, an endorser, or an *avaliseur* may, by the stipulation *"retour sans frais", "sans protêt",* or any other equivalent expression written on the instrument and signed, release the holder from having a protest drawn up or an equivalent declaration made in order to exercise his right of recourse.

This stipulation does not release the holder from presenting the cheque within the prescribed limit of time, or from giving the requisite notices. The burden of proving the non-observance of the limit of time lies on the person who seeks to set it up against the holder.

If the stipulation is written by the drawer, it is operative in respect of all persons who have signed the cheque; if it is written by an endorser or an *avaliseur*, it is operative only in respect of such endorser or *avaliseur*. If, in spite of the stipulation written by the drawer, the holder has the protest drawn up or the equivalent declaration made, he must bear the expenses thereof. When the stipulation emanates from an endorser or *avaliseur*, the costs of the protest or equivalent declaration, if drawn up or made, may be recovered from all the persons who have signed the cheque.

Article 44

All the persons liable on a cheque are jointly and severally bound to the holder.

The holder has the right to proceed against all these persons individually or collectively without being compelled to observe the order in which they have become bound.

The same right is possessed by any person signing the cheque who has taken it up and paid it.

Proceedings against one of the parties liable do not prevent proceedings against the others, even though such other parties may be subsequent to the party first proceeded against.

Article 45

The holder may claim from the party against whom he exercises his right of recourse:

(1) The unpaid amount of the cheque;

(2) Interest at the rate of 6% as from the date of presentment;

(3) The expenses of the protest or equivalent declaration, and of the notices given as well as other expenses.

Article 46

A party who takes up and pays a cheque can recover from the parties liable to him:

(1) The entire sum which he has paid;

(2) Interest on the said sum calculated at the rate of 6%, as from the day on which he made payment;

(3) Any expenses which he has incurred.

Article 47

Every party liable against whom a right of recourse is, or may be, exercised, can require against payment, that the cheque shall be given up to him with the protest or equivalent declaration and a receipted account.

Every endorser who has taken up and paid a cheque may cancel his own endorsement and those of subsequent endorsers.

Article 48

Should the presentment of the cheque or the drawing up of the protest or the making of the equivalent declaration within the prescribed limits of time be prevented by an insurmountable obstacle (legal prohibition *(prescription légale)* by any State or other case of *vis major*), these limits of time shall be extended.

The holder is bound to give notice without delay of the case of *vis major* to his endorser and to make a dated and signed declaration of this notice, on the cheque or on an *allonge*; in other respects, the provisions of Article 42 shall apply.

When *vis major* has terminated, the holder must without delay present the cheque for payment and, if need be, procure a protest to be drawn up or an equivalent declaration made.

If *vis major* continues to operate beyond fifteen days after the date on which the holder, even before the expiration of the time-limit for presentment, has given notice of *vis major* to his endorser, recourse may be exercised and neither presentment nor a protest nor an equivalent declaration shall be necessary.

Facts which are purely personal to the holder or the person whom he has entrusted with the presentment of the cheque or the drawing up of the protest or the making of the equivalent declaration are not deemed to constitute cases of *vis major*.

CHAPTER VII. PARTS OF A SET

Article 49

With the exception of bearer cheques, any cheque issued in one country and payable in another or payable in a separate part overseas of the

same country or *vice versa*, or issued and payable in the same or in different parts overseas of the same country, may be drawn in a set of identical parts. When a cheque is in a set of parts, each part must be numbered in the body of the instrument, failing which each part is deemed to be a separate cheque.

Article 50

Payment made on one part operates as a discharge, even though there is no stipulation that such payment shall render the other parts of no effect.

An endorser who has negotiated parts to different persons and also the endorsers subsequent to him are liable on all the parts bearing their signatures, which have not been given up.

CHAPTER VIII. ALTERATIONS

Article 51

In case of alteration of the text of a cheque, parties who have signed subsequent to the alteration are bound according to the terms of the altered text; parties who have signed before the alteration are bound according to the terms of the original text.

CHAPTER IX. LIMITATION OF ACTIONS

Article 52

Actions of recourse by the holder against the endorsers, the drawer and the other parties liable are barred after six months as from the expiration of the limit of time fixed for presentment.

Actions of recourse by the different parties liable for the payment of a cheque against other such parties are barred after six months as from the day on which the party liable has paid the cheque or the day on which he was sued thereon.

Article 53

Interruption of the period of limitation is only effective against the person in respect of whom the period has been interrupted.

CHAPTER X. GENERAL PROVISIONS

Article 54

In the present law the word "banker" includes the persons or institutions assimilated by the law to bankers.

Article 55

The presentment or protest of a cheque may only take place on a business day.

When the last day of the limit of time prescribed by the law for performing any act relating to a cheque, and particularly for presentment or for the drawing up of a protest or the making of an equivalent declaration, is a legal holiday, the limit of time is extended until the first business day which follows the expiration of that time. Intermediate holidays are included in computing limits of time.

Article 56

The limits of time stipulated in the present law shall not include the day on which the period commences.

Article 57

No days of grace, whether legal or judicial, are permitted.

ANNEX II

Article 1

Each of the High Contracting Parties may prescribe that the obligation to insert in cheques drawn in his territory the term "cheque", as laid down in Article 1, No. 1 of the Uniform Law, and the obligation stipulated in No. 5 of the said article to state the place where the cheque was drawn, shall not apply until six months after the entry into force of the present Convention.

Article 2

Each of the High Contracting Parties may, as regards undertakings entered into in respect of cheques in his own territory, determine in what manner an actual signature may be replaced by an authentic declaration written on the cheque which evidences the consent of the party who should have signed.

Article 3

By way of derogation from Article 2, paragraph 3, of the Uniform Law, each of the High Contracting Parties may prescribe that a cheque which

does not specify the place of payment shall be regarded as payable at the place where it was drawn.

Article 4

Each of the High Contracting Parties reserves the right, with regard to cheques issued and payable in his territory, to decide that instruments drawn on persons other than bankers or persons or institutions assimilated by the law to bankers, shall not be valid as cheques.

Each of the High Contracting Parties also reserves the right to embody Article 3 of the Uniform Law in his national law in the form and in the terms best suited to the use he may make of the provisions of the preceding paragraph.

Article 5

Each of the High Contracting Parties may determine the moment at which the drawer must have funds available with the drawee.

Article 6

Each of the High Contracting Parties may provide that a drawee may write on the cheque a statement of certification, confirmation, visa, or other equivalent declaration, provided that such declaration shall not operate as an acceptance, and may also determine the legal effects thereof.

Article 7

By way of derogation from Articles 5 and 14 of the Uniform Law, each of the High Contracting Parties reserves the right to prescribe, as regards cheques payable in his territory, and marked "not transferable", that a cheque of this description may be paid only to the holder who has received it thus marked.

Article 8

Each of the High Contracting Parties reserves the right to determine whether, apart from the cases referred to in Article 6 of the Uniform Law, a cheque may be drawn on the drawer himself.

Article 9

By way of derogation from Article 6 of the Uniform Law, each of the High Contracting Parties, whether as a general rule he allows cheques to

be drawn on the drawer himself (Article 8 of the present Annex), or whether he allows such cheques to be drawn only in the case of businesses with several establishments (Article 6 of the Uniform Law), reserves the right to prohibit the issue of cheques of this kind to bearer.

Article 10

By way of derogation from Article 8 of the Uniform Law, each of the High Contracting Parties reserves the right to allow a cheque to be made payable at the domicile of a third person other than a banker.

Article 11

Each of the High Contracting Parties reserves the right not to embody Article 13 of the Uniform Law in his national law.

Article 12

Each of the High Contracting Parties reserves the right not to apply Article 21 of the Uniform Law so far as bearer cheques are concerned.

Article 13

By way of derogation from Article 26 of the Uniform Law, each of the High Contracting Parties has the right to decide that an "aval" may be given in his territory by a separate instrument specifying the place in which the instrument has been executed.

Article 14

Each of the High Contracting Parties reserves the right to prolong the time-limit provided for in the first paragraph of Article 29 of the Uniform Law and to fix the limits of time for presentment as regards the territories under his sovereignty or authority.

Each of the High Contracting Parties, by way of derogation from Article 29, paragraph 2, of the Uniform Law, reserves the right to prolong the time-limits provided for in the said paragraph for cheques issued and payable in different continents or in different countries in a continent other than Europe.

Two or more of the High Contracting Parties may agree, as regards cheques issued and payable in their respective territories, to modify the time-limits provided for in Article 29, paragraph 2, of the Uniform Law.

Article 15

For the purpose of giving effect to Article 31 of the Uniform Law, each of the High Contracting Parties may determine the institutions which according to his national law are to be regarded as clearing-houses.

Article 16

By way of derogation from Article 32 of the Uniform Law, each of the High Contracting Parties reserves the right in regard to cheques payable in his territory:

(a) To allow the countermand of a cheque even before the expiration of the limit of the time for presentment;

(b) To prohibit the countermand of a cheque even after the expiration of the limit of time for presentment.

Furthermore, each of the High Contracting Parties may determine the measures to be taken in case of the loss or theft of a cheque, and may regulate the legal consequences thereof.

Article 17

Each of the High Contracting Parties may, if he deems it necessary, in exceptional circumstances connected with the rate of exchange of the currency of his country, derogate from the stipulation contained in Article 36 of the Uniform Law for effective payment in foreign currency as regards cheques payable in his territory. The above rule may also be applied as regards the issue in the national territory of cheques payable in foreign currency.

Article 18

Each of the High Contracting Parties reserves the right, by way of derogation from Articles 37, 38, and 39 of the Uniform Law, to recognise in his national law only crossed cheques or only cheques payable in account. Nevertheless, crossed cheques and cheques payable in account issued abroad and payable in the territory of each of the High Contracting Parties shall be treated as cheques payable in account and as crossed cheques respectively.

Each of the High Contracting Parties may also determine the wording which, under its national law, shall indicate that the cheque is a cheque payable in account.

Article 19

The question whether the holder has special rights to the cover and the consequences of these rights remain outside the scope of the Uniform Law.

The same applies to any other question concerning the legal relations on the basis of which the cheque is issued.

Article 20

Each of the High Contracting Parties reserves the right not to make it a condition for the exercise of the right of recourse against the drawer that the cheque must be presented and the protest drawn up or an equivalent declaration made within due time, and to determine the effects of this recourse.

Article 21

Each of the High Contracting Parties reserves the right to prescribe, as regards cheques payable in his territory, that the declaration of the refusal of payment stipulated in Articles 40 and 41 of the Uniform Law as a condition of the preservation of the right of recourse must in each and every case take the form of a protest to the exclusion of any equivalent declaration.

Each of the High Contracting Parties may also prescribe that the declarations provided for in Nos. 2 and 3 of Article 40 of the Uniform Law must be entered in a public register within the limit of time fixed for the protest.

Article 22

By way of derogation from Article 42 of the Uniform Law, each of the High Contracting Parties may maintain or introduce the following system of notification by the public official—viz., that, when drawing up the protest, the notary or official who, under the national law, is authorised to draw up the protest is required to give notice in writing to the persons liable on the cheque whose addresses are specified in the cheque or are known to the public official drawing up the protest, or are specified by the persons demanding the protest. The expenses of such notice shall be added to the expenses of the protest.

Article 23

Each of the High Contracting Parties may prescribe, as regards cheques which are both issued and payable in his territory, that the rate of interest

mentioned in Article 45, No. 2, and in Article 46, No. 2, of the Uniform Law may be replaced by the legal rate in force in his territory.

Article 24

By way of derogation from Article 45 of the Uniform Law, each of the High Contracting Parties reserves the right to insert in his national law a rule prescribing that the holder may claim from the party against whom he is exercising his right of recourse a commission the amount of which shall be determined by that law.

By way of derogation from Article 46 of the Uniform Law, the same applies to a person who, having taken up and paid the cheque, claims the amount from the parties liable to him.

Article 25

Each of the High Contracting Parties is free to decide that, in the event of forfeiture of rights or limitation of actions, proceedings may be taken in his territory against a drawer who has not provided cover or against a drawer or endorser who has made an inequitable gain *(condictiones)*.

Article 26

It is for the legislation of each of the High Contracting Parties to determine the causes of interruption or suspension of limitation in the case of actions on cheques which are brought before his courts.

The other High Contracting Parties may determine the conditions under which they will recognise such causes. The same applies to the effect of an action as a means of indicating the commencement of the period of limitation laid down in Article 52, paragraph 2, of the Uniform Law.

Article 27

Each of the High Contracting Parties may prescribe that certain business days shall be assimilated to legal holidays as regards the limit of time for presentment and all acts relating to cheques.

Article 28

Each of the High Contracting Parties may enact exceptional measures of a general nature relating to the postponement of payment and to the limits of time for conservatory measures in relation to recourse *(actes conservatoires des recours)*.

Article 29

For the purpose of giving effect to the Uniform Law, it is within the competence of each of the High Contracting Parties to determine what persons are to be regarded as bankers and what persons or institutions are, in view of the nature of their activities, to be assimilated to bankers.

Article 30

Each of the High Contracting Parties reserves the right to exclude the application of the Uniform Law in whole or in part in regard to postal cheques, and in regard to the special cheque of banks of issue or of public revenue offices or of public credit institutions, in so far as the instruments mentioned above are subject to special regulations.

Article 31

Each of the High Contracting Parties undertakes to recognise the provisions adopted by every other High Contracting Party in virtue of Articles 1 to 13, 14 (paragraphs 1 and 2), 15 and 16, 18 to 25, 27, 29 and 30 of the present Annex.

Appendix II

3 U.K. Bills of Exchange Act, 1882[1]

Part I[2]

Preliminary

1. **Short title.** This Act may be cited as the Bills of Exchange Act, 1882.

2. **Interpretation of terms.** In this Act, unless the context otherwise requires,—

"Acceptance" means an acceptance completed by delivery or notification.

"Action" includes counter claim and set off.

"Banker" includes a body of persons whether incorporated or not who carry on the business of banking.

"Bankrupt" includes any person whose estate is vested in a trustee or assignee under the law for the time being in force relating to bankruptcy.

"Bearer" means the person in possession of a bill or note which is payable to bearer.

"Bill" means bill of exchange, and "note" means promissory note.

"Delivery" means transfer of possession, actual or constructive, from one person to another.

"Holder" means the payee or indorsee of a bill or note who is in possession of it, or the bearer thereof.

"Indorsement" means an indorsement completed by delivery.

"Issue" means the first delivery of a bill or note, complete in form to a person who takes it as a holder.

"Person" includes a body of persons whether incorporated or not.

"Value" means valuable consideration.

"Written" includes printed, and "writing" includes print.

[1]Footnotes omitted.

[2]Bills of Exchange Act, 1882, 45 & 46 Victoria, chapter 61 (as amended). This text includes amendments through November 28, 1996.

Part II

Bills of Exchange

Form and Interpretation

3. Bill of exchange defined. (1) A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to bearer.

(2) An instrument which does not comply with these conditions, or which orders any act to be done in addition to the payment of money, is not a bill of exchange.

(3) An order to pay out of a particular fund is not unconditional within the meaning of this section; but an unqualified order to pay, coupled with (a) an indication of a particular fund out of which the drawee is to re-imburse himself or a particular account to be debited with the amount, or (b) a statement of the transaction which gives rise to the bill, is unconditional.

(4) A bill is not invalid by reason—

(a) That it is not dated;

(b) That it does not specify the value given, or that any value has been given therefor;

(c) That it does not specify the place where it is drawn or the place where it is payable.

4. Inland and foreign bills. (1) An inland bill is a bill which is or on the face of it purports to be

(a) both drawn and payable within the British Islands, or

(b) drawn within the British Islands upon some person resident therein. Any other bill is a foreign bill.

For the purposes of this Act "British Islands" mean any part of the United Kingdom of Great Britain and Ireland, the islands of Man, Guernsey, Jersey, Alderney, and Sark, and the islands adjacent to any of them being part of the dominions of Her Majesty.

(2) Unless the contrary appear on the face of the bill the holder may treat it as an inland bill.

5. Effect where different parties to bill are the same person. (1) A bill may be drawn payable to, or to the order of, the drawer; or it may be drawn payable to, or to the order of, the drawee.

(2) Where in a bill drawer and drawee are the same person, or where the drawee is a fictitious person or a person not having capacity to contract, the holder may treat the instrument, at his option, either as a bill of exchange or as a promissory note.

6. Address to drawee. (1) The drawee must be named or otherwise indicated in a bill with reasonable certainty.

(2) A bill may be addressed to two or more drawees whether they are partners or not, but an order addressed to two drawees in the alternative or to two or more drawees in succession is not a bill of exchange.

7. Certainty required as to payee. (1) Where a bill is not payable to bearer, the payee must be named or otherwise indicated therein with reasonable certainty.

(2) A bill may be made payable to two or more payees jointly, or it may be made payable in the alternative to one of two, or one or some of several payees. A bill may also be made payable to the holder of an office for the time being.

(3) Where the payee is a fictitious or non-existing person the bill may be treated as payable to bearer.

8. What bills are negotiable. (1) When a bill contains words prohibiting transfer, or indicating an intention that it should not be transferable, it is valid as between the parties thereto, but is not negotiable.

(2) A negotiable bill may be payable either to order or to bearer.

(3) A bill is payable to bearer which is expressed to be so payable, or on which the only or last indorsement is an indorsement in blank.

(4) A bill is payable to order which is expressed to be so payable, or which is expressed to be payable to a particular person, and does not contain words prohibiting transfer or indicating an intention that it should not be transferable.

(5) Where a bill, either originally or by indorsement, is expressed to be payable to the order of a specified person, and not to him or his order, it is nevertheless payable to him or his order at his option.

9. Sum payable. (1) The sum payable by a bill is a sum certain within the meaning of this Act, although it was required to be paid—

(a) With interest.

(b) By stated instalments.

(c) By stated instalments, with a provision that upon default in payment of any instalment the whole shall become due.

(d) According to an indicated rate of exchange or according to a rate of exchange to be ascertained as directed by the bill.

(2) Where the sum payable is expressed in words and also in figures, and there is a discrepancy between the two, the sum denoted by the words is the amount payable.

(3) Where a bill is expressed to be payable with interest, unless the instrument otherwise provides, interest runs from the date of the bill, and if the bill is undated from the issue thereof.

10. Bill payable on demand. (1) A bill is payable on demand—

(a) Which is expressed to be payable on demand, or at sight, or on presentation; or

(b) In which no time for payment was expressed.

(2) Where a bill is accepted or indorsed when it is overdue, it shall, as regards the acceptor who so accepts, or any indorser who so indorses it, be deemed a bill payable on demand.

11. Bill payable at a future time. A bill is payable at a determinable future time within the meaning of this Act which is expressed to be payable—

(1) At a fixed period after date or sight.

(2) On or at a fixed period after the occurrence of a specified event which is certain to happen, though the time of happening may be uncertain.

An instrument expressed to be payable on a contingency is not a bill, and the happening of the event does not cure the defect.

12. Omission of date in bill payable after date. Where a bill expressed to be payable at a fixed period after date is issued undated, or where the acceptance of a bill payable at a fixed period after sight is undated, any holder may insert therein the true date of issue or acceptance, and the bill shall be payable accordingly.

Provided that (1) where the holder in good faith and by mistake inserts a wrong date, and (2) in every case where a wrong date is inserted, if the bill subsequently comes into the hands of a holder in due course the bill

shall not be avoided thereby, but shall operate and be payable as if the date so inserted had been the true date.

13. Ante-dating and post-dating. (1) Where a bill or an acceptance or any indorsement on a bill is dated, the date shall, unless the contrary be proved, be deemed to be the true date of the drawing, acceptance, or indorsement, as the case may be.

(2) A bill is not invalid by reason only that it is ante-dated or post-dated, or that it bears date on a Sunday.

14. Computation of time of payment. Where a bill is not payable on demand the day on which it falls due is determined as follows:

(1) Three days, called days of grace, are, in every case where the bill itself does not otherwise provide, added to the time of payment as fixed by the bill, and the bill is due and payable on the last day of grace: Provided that—

(a) When the last day of grace falls on Sunday, Christmas Day, Good Friday, or a day appointed by Royal proclamation as a public fast or thanksgiving day, the bill is, except in the case herein-after provided for, due and payable on the preceding business day;

(b) When the last day of grace is a bank holiday (other than Christmas Day or Good Friday) under the Bank Holidays Act, 1871, and Acts amending or extending it, or when the last day of grace is a Sunday, and the second day of grace is a Bank Holiday, the bill is due and payable on the succeeding business day.

(2) Where a bill is payable at a fixed period after date, after sight, or after the happening of a specified event, the time of payment is determined by excluding the day from which the time is to begin to run and by including the day of payment.

(3) Where a bill is payable at a fixed period after sight, the time begins to run from the date of the acceptance if the bill be accepted, and from the date of noting or protest if the bill be noted or protested for non-acceptance, or for non-delivery.

(4) The term "month" in a bill means calendar month.

15. Case of need. The drawer of a bill and any indorser may insert therein the name of a person to whom the holder may resort in case of need, that is to say, in case the bill is dishonoured by non-acceptance or non-payment. Such person is called the referee in case of need. It is in the option of the holder to resort to the referee in case of need or not as he may think fit.

16. Optional stipulations by drawer or indorser. The drawer of a bill, and any indorser, may insert therein an express stipulation—

(1) negativing or limiting his own liability to the holder.

(2) waiving as regards himself some or all of the holder's duties.

17. Definition and requisites of acceptance. (1) The acceptance of a bill is the signification by the drawee of his assent to the order of the drawer.

(2) An acceptance is invalid unless it complies with the following conditions, namely:

(a) It must be written on the bill and be signed by the drawee. The mere signature of the drawee without additional words is sufficient.

(b) It must not express that the drawee will perform his promise by any other means than the payment of money.

18. Time for acceptance. A bill may be accepted—

(1) before it has been signed by the drawer, or while otherwise incomplete:

(2) when it is overdue, or after it has been dishonoured by a previous refusal to accept, or by non-payment:

(3) when a bill payable after sight is dishonoured by non-acceptance, and the drawee subsequently accepts it, the holder, in the absence of any different agreement, is entitled to have the bill accepted as of the date of first presentment to the drawee for acceptance.

19. General and qualified acceptances. (1) An acceptance is either

(a) general or

(b) qualified.

(2) A general acceptance assents without qualification to the order of the drawer. A qualified acceptance in express terms varies the effect of the bill as drawn.

In particular an acceptance is qualified which is—

(a) conditional, that is to say, which makes payment by the acceptor dependent on the fulfilment of a condition therein stated:

(b) partial, that is to say, an acceptance to pay part only of the amount for which the bill is drawn:

(c) local, that is to say, an acceptance to pay only at a particular specified place:

An acceptance to pay at a particular place is a general acceptance, unless it expressly states that the bill is to be paid there only and not elsewhere:

(d) qualified as to time:

(e) the acceptance of some one or more of the drawees, but not of all.

20. Inchoate instruments. (1) Where a simple signature on a blank stamped paper is delivered by the signer in order that it may be converted into a bill, it operates as a primâ facie authority to fill it up as a complete bill for any amount the stamp will cover, using the signature for that of the drawer, or the acceptor, or an indorser; and, in like manner, when a bill is wanting in any material particular, the person in possession of it has a primâ facie authority to fill up the omission in any way he thinks fit.

(2) In order that any such instrument when completed may be enforceable against any person who became a party thereto prior to its completion, it must be filled up within a reasonable time, and strictly in accordance with the authority given. Reasonable time for this purpose is a question of fact.

Provided that if any such instrument after completion is negotiated to a holder in due course it shall be valid and effectual for all purposes in his hands, and he may enforce it as if it had been filled up within a reasonable time and strictly in accordance with the authority given.

21. Delivery. (1) Every contract on a bill, whether it be the drawer's, the acceptor's, or an indorser's, is incomplete and revocable, until delivery of the instrument in order to give effect thereto.

Provided that where an acceptance is written on a bill, and the drawee gives notice to or according to the directions of the person entitled to the bill that he has accepted it, the acceptance then becomes complete and irrevocable.

(2) As between immediate parties, and as regards a remote party other than a holder in due course, the delivery—

(a) in order to be effectual must be made either by or under the authority of the party drawing, accepting, or indorsing, as the case may be.

(b) may be shown to have been conditional or for a special purpose only, and not for the purpose of transferring the property in the bill.

But if the bill be in the hands of a holder in due course a valid delivery of the bill by all parties prior to him so as to make them liable to him is conclusively presumed.

(3) Where a bill is no longer in the possession of a party who has signed it as drawer, acceptor, or indorser, a valid and unconditional delivery by him is presumed until the contrary is proved.

Capacity and Authority of Parties

22. Capacity of parties. (1) Capacity to incur liability as a party to a bill is co-extensive with capacity to contract.

Provided that nothing in this section shall enable a corporation to make itself liable as drawer, acceptor, or indorser of a bill unless it is competent to it so to do under the law for the time being in force relating to corporations.

(2) Where a bill is drawn or indorsed by an infant, minor, or corporation having no capacity or power to incur liability on a bill, the drawing or indorsement entitles the holder to receive payment of the bill, and to enforce it against any other party thereto.

23. Signature essential to liability. No person is liable as drawer, indorser, or acceptor of a bill who has not signed it as such: Provided that

(1) Where a person signs a bill in a trade or assumed name, he is liable thereon as if he had signed it in his own name:

(2) The signature of the name of a firm is equivalent to the signature by the person so signing of the names of all persons liable as partners in that firm.

24. Forged or unauthorised signature. Subject to the provisions of this Act, where a signature on a bill is forged or placed thereon without the authority of the person whose signature it purports to be, the forged or unauthorised signature is wholly inoperative, and no right to retain the bill or to give a discharge therefor or to enforce payment thereof against any party thereto can be acquired through or under that signature, unless the party against whom it is sought to retain or enforce payment of the bill is precluded from setting up the forgery or want of authority.

Provided that nothing in this section shall affect the ratification of an unauthorised signature not amounting to a forgery.

25. Procuration signatures. A signature by procuration operates as notice that the agent has but a limited authority to sign, and the principal is only bound by such signature if the agent in so signing was acting within the actual limits of his authority.

26. Person signing as agent or in representative capacity. (1) Where a person signs a bill as drawer, indorser, or acceptor, and adds words to his signature, indicating that he signs for or on behalf of a principal, or in a representative character, he is not personally liable thereon; but the mere addition to his signature of words describing him as an agent, or as filling a representative character, does not exempt him from personal liability.

(2) In determining whether a signature on a bill is that of the principal or that of the agent by whose hand it is written, the construction most favourable to the validity of the instrument shall be adopted.

The Consideration for a Bill

27. Value and holder for value. (1) Valuable consideration for a bill may be constituted by—

(a) any consideration sufficient to support a simple contract;

(b) an antecedent debt or liability. Such a debt or liability is deemed valuable consideration whether the bill is payable on demand or at a future time.

(2) Where value has at any time been given for a bill the holder is deemed to be a holder for value as regards the acceptor and all parties to the bill who became parties prior to such time.

(3) Where the holder of a bill has a lien on it arising either from contract or by implication of law, he is deemed to be a holder for value to the extent of the sum for which he has a lien.

28. Accommodation bill or party. (1) An accommodation party to a bill is a person who has signed a bill as drawer, acceptor, or indorser, without receiving value therefor, and for the purpose of lending his name to some other person.

(2) An accommodation party is liable on the bill to a holder for value; and it is immaterial whether, when such holder took the bill, he knew such party to be an accommodation party or not.

29. Holder in due course. (1) A holder in due course is a holder who has taken a bill, complete and regular on the face of it, under the following conditions; namely,

(a) That he became the holder of it before it was overdue, and without notice that it had been previously dishonoured, if such was the fact:

(b) That he took the bill in good faith and for value, and that at the time the bill was negotiated to him he had no

notice of any defect in the title of the person who negotiated it.

(2) In particular, the title of a person who negotiates a bill is defective within the meaning of this Act when he obtained the bill, or the acceptance thereof, by fraud, duress, or force and fear, or other unlawful means, or an illegal consideration, or when he negotiates it in breach of faith, or under such circumstances as amount to a fraud.

(3) A holder (whether for value or not), who derives his title to a bill through a holder in due course, and who is not himself a party to any fraud or illegality affecting it, has all the rights of that holder in due course as regards the acceptor and all parties to the bill prior to that holder.

30. Presumption of value and good faith. (1) Every party whose signature appears on a bill is primâ facie deemed to have become a party thereto for value.

(2) Every holder of a bill is primâ facie deemed to be a holder in due course; but if in an action on a bill it is admitted or proved that the acceptance, issue, or subsequent negotiation of the bill is affected with fraud, duress, or force and fear, or illegality, the burden of proof is shifted, unless and until the holder proves that subsequent to the alleged fraud or illegality, value has in good faith been given for the bill.

Negotiation of Bills

31. Negotiation of bill. (1) A bill is negotiated when it is transferred from one person to another in such a manner as to constitute the transferee the holder of the bill.

(2) A bill payable to bearer is negotiated by delivery.

(3) A bill payable to order is negotiated by the indorsement of the holder completed by delivery.

(4) Where the holder of a bill payable to his order transfers it for value without indorsing it, the transfer gives the transferee such title as the transferor had in the bill, and the transferee in addition acquires the right to have the indorsement of the transferor.

(5) Where any person is under obligation to indorse a bill in a representative capacity, he may indorse the bill in such terms as to negative personal liability.

32. Requisites of a valid indorsement. An indorsement in order to operate as a negotiation must comply with the following conditions, namely—

(1) It must be written on the bill itself and be signed by the indorser. The simple signature of the indorser on the bill, without additional words, is sufficient.

An indorsement written on an allonge, or on a "copy" of a bill issued or negotiated in a country where "copies" are recognised, is deemed to be written on the bill itself.

(2) It must be an indorsement of the entire bill. A partial indorsement, that is to say, an indorsement which purports to transfer to the indorsee a part only of the amount payable, or which purports to transfer the bill to two or more indorsees severally, does not operate as a negotiation of the bill.

(3) Where a bill is payable to the order of two or more payees or indorsees who are not partners all must indorse, unless the one indorsing has authority to indorse for the others.

(4) Where, in a bill payable to order, the payee or indorsee is wrongly designated, or his name is mis-spelt, he may indorse the bill as therein described, adding, if he think fit, his proper signature.

(5) Where there are two or more indorsements on a bill, each indorsement is deemed to have been made in the order in which it appears on the bill, until the contrary is proved.

(6) An indorsement may be made in blank or special. It may also contain terms making it restrictive.

33. Conditional indorsement. Where a bill purports to be indorsed conditionally the condition may be disregarded by the payer, and payment to the indorsee is valid whether the condition has been fulfiled or not.

34. Indorsement in blank and special indorsement. (1) An indorsement in blank specifies no indorsee, and a bill so indorsed becomes payable to bearer.

(2) A special indorsement specifies the person to whom, or to whose order, the bill is to be payable.

(3) The provisions of this Act relating to a payee apply with the necessary modifications to an indorsee under a special indorsement.

(4) When a bill has been indorsed in blank, any holder may convert the blank indorsement into a special indorsement by writing above the indorsee's signature a direction to pay the bill to or to the order of himself or some other person.

35. Restrictive indorsement. (1) An indorsement is restrictive which prohibits the further negotiation of the bill or which expresses that

it is a mere authority to deal with the bill as thereby directed and not a transfer of the ownership thereof, as, for example, if a bill be indorsed "Pay D. only," or "Pay D. for the account of X.," or "Pay D. or order for collection."

(2) A restrictive indorsement gives the indorsee the right to receive payment of the bill and to sue any party thereto that his indorser could have sued, but gives him no power to transfer his rights as indorsee unless it expressly authorise him to do so.

(3) Where a restrictive indorsement authorises further transfer, all subsequent indorsees take the bill with the same rights and subject to the same liabilities as the first indorsee under the restrictive indorsement.

36. Negotiation of overdue or dishonoured bill. (1) Where a bill is negotiable in its origin it continues to be negotiable until it has been

(a) restrictively indorsed or

(b) discharged by payment or otherwise.

(2) Where an overdue bill is negotiated, it can only be negotiated subject to any defect of title affecting it at its maturity, and thenceforward no person who takes it can acquire or give a better title than that which the person from whom he took it had.

(3) A bill payable on demand is deemed to be overdue within the meaning and for the purposes of this section, when it appears on the face of it to have been in circulation for an unreasonable length of time. What is an unreasonable length of time for this purpose is a question of fact.

(4) Except where an indorsement bears date after the maturity of the bill, every negotiation is primâ facie deemed to have been effected before the bill was overdue.

(5) Where a bill which is not overdue has been dishonoured any person who takes it with notice of the dishonour takes it subject to any defect of title attaching thereto at the time of dishonour, but nothing in this subsection shall affect the rights of a holder in due course.

37. Negotiation of bill to party already liable thereon. Where a bill is negotiated back to the drawer, or to a prior indorser or to the acceptor, such party may, subject to the provisions of this Act, re-issue and further negotiate the bill, but he is not entitled to enforce payment of the bill against any intervening party to whom he was previously liable.

38. Rights of the holder. The rights and powers of the holder of a bill are as follows:

(1) He may sue on the bill in his own name:

(2) Where he is a holder in due course, he holds the bill free from any defect of title of prior parties, as well as from mere personal defences available to prior parties among themselves, and may enforce payment against all parties liable on the bill:

(3) Where his title is defective:

(a) if he negotiates the bill to a holder in due course, that holder obtains a good and complete title to the bill, and

(b) if he obtains payment of the bill the person who pays him in due course gets a valid discharge for the bill.

General Duties of the Holder

39. When presentment for acceptance is necessary. (1) Where a bill is payable after sight, presentment for acceptance is necessary in order to fix the maturity of the instrument.

(2) Where a bill expressly stipulates that it shall be presented for acceptance, or where a bill is drawn payable elsewhere than at the residence or place of business of the drawee, it must be presented for acceptance before it can be presented for payment.

(3) In no other case is presentment for acceptance necessary in order to render liable any party to the bill.

(4) Where the holder of a bill, drawn payable elsewhere than at the place of business or residence of the drawee, has not time, with the exercise of reasonable diligence, to present the bill for acceptance before presenting it for payment on the day that it falls due, the delay caused by presenting the bill for acceptance before presenting it for payment is excused, and does not discharge the drawer and indorsers.

40. Time for presenting bill payable after sight. (1) Subject to the provisions of this Act, when a bill payable after sight is negotiated, the holder must either present it for acceptance or negotiate it within a reasonable time.

(2) If he does not do so, the drawer and all indorsers prior to that holder are discharged.

(3) In determining what is a reasonable time within the meaning of this section, regard shall be had to the nature of the bill, the usage of trade with respect to similar bills, and the facts of the particular case.

41. Rules as to presentment for acceptance, and excuses for non-presentment. (1) A bill is duly presented for acceptance which is presented in accordance with the following rules:

(a) The presentment must be made by or on behalf of the holder to the drawee or to some person authorised to accept or refuse acceptance on his behalf at a reasonable hour on a business day and before the bill is overdue:

(b) Where a bill is addressed to two or more drawees, who are not partners, presentment must be made to them all, unless one has authority to accept for all, then presentment may be made to him only:

(c) Where the drawee is dead, presentment may be made to his personal representative:

(d) Where the drawee is bankrupt, presentment may be made to him or to his trustee:

(e) Where authorised by agreement or usage, a presentment through the post office is sufficient.

(2) Presentment in accordance with these rules is excused, and a bill may be treated as dishonoured by non-acceptance—

(a) Where the drawee is dead or bankrupt, or is a fictitious person or a person not having capacity to contract by bill:

(b) Where, after the exercise of reasonable diligence, such presentment cannot be effected:

(c) Where, although the presentment has been irregular, acceptance has been refused on some other ground.

(3) The fact that the holder has reason to believe that the bill, on presentment, will be dishonoured does not excuse presentment.

42. Non-acceptance. When a bill is duly presented for acceptance and is not accepted within the customary time, the person presenting it must treat it as dishonoured by non-acceptance. If he does not, the holder shall lose his right of recourse against the drawer and indorsers.

43. Dishonour by non-acceptance and its consequences. (1) A bill is dishonoured by non-acceptance—

(a) when it is duly presented for acceptance, and such an acceptance as is prescribed by this Act is refused or cannot be obtained; or

(b) when presentment for acceptance is excused and the bill is not accepted.

(2) Subject to the provisions of this Act when a bill is dishonoured by non-acceptance, an immediate right of recourse against the

drawer and indorsers accrues to the holder, and no presentment for payment is necessary.

44. Duties as to qualified acceptances. (1) The holder of a bill may refuse to take a qualified acceptance, and if he does not obtain an unqualified acceptance may treat the bill as dishonoured by non-acceptance.

(2) Where a qualified acceptance is taken, and the drawer or an indorser has not expressly or impliedly authorised the holder to take a qualified acceptance, or does not subsequently assent thereto, such drawer or indorser is discharged from his liability on the bill.

The provisions of this subsection do not apply to a partial acceptance, whereof due notice has been given. Where a foreign bill has been accepted as to part, it must be protested as to the balance.

(3) When the drawer or indorser of a bill receives notice of a qualified acceptance, and does not within reasonable time express his dissent to the holder he shall be deemed to have assented thereto.

45. Rules as to presentment for payment. Subject to the provisions of this Act a bill must be duly presented for payment. If it be not so presented the drawer and indorsers shall be discharged.

A bill is duly presented for payment which is presented in accordance with the following rules—

(1) Where the bill is not payable on demand, presentment must be made on the day it falls due.

(2) Where the bill is payable on demand, then, subject to the provisions of the Act, presentment must be made within a reasonable time after its issue in order to render the drawer liable, and within a reasonable time after its indorsement, in order to render the indorser liable.

In determining what is a reasonable time, regard shall be had to the nature of the bill, the usage of trade with regard to similar bills, and the facts of the particular case.

(3) Presentment must be made by the holder or by some person authorised to receive payment on his behalf at a reasonable hour on a business day, at the proper place as herein-after defined, either to the person designated by the bill as payer, or to some person authorised to pay or refuse payment on his behalf if with the exercise of reasonable diligence such person can there be found.

(4) A bill is presented at the proper place—

(a) where a place of payment is specified in the bill and the bill is there presented.

(b) where no place of payment is specified, but the address of the drawee or acceptor is given in the bill, and the bill is there presented.

(c) where no place of payment is specified and no address given, and the bill is presented at the drawee's or acceptor's place of business if known, and if not, at his ordinary residence if known.

(d) in any other case if presented to the drawee or acceptor wherever he can be found, or if presented at his last known place of business or residence.

(5) Where a bill is presented at the proper place, and after the exercise of reasonable diligence no person authorised to pay or refuse payment can be found there, no further presentment to the drawee or acceptor is required.

(6) Where a bill is drawn upon, or accepted by two or more persons who are not partners, and no place of payment is specified, presentment must be made to them all.

(7) Where the drawee or acceptor of a bill is dead, and no place of payment is specified, presentment must be made to a personal representative, if such there be, and with the exercise of reasonable diligence he can be found.

(8) Where authorised by agreement or usage a presentment through the post office is sufficient.

46. Excuses for delay or non-presentment for payment. (1) Delay in making presentment for payment is excused when the delay is caused by circumstances beyond the control of the holder, and not imputable to his default, misconduct, or negligence. When the cause of delay ceases to operate presentment must be made with reasonable diligence.

(2) Presentment for payment is dispensed with—

(a) where, after the exercise of reasonable diligence presentment, as required by this Act, cannot be effected.

The fact that the holder has reason to believe that the bill will, on presentment, be dishonoured, does not dispense with the necessity for presentment.

(b) where the drawee is a fictitious person.

(c) as regards the drawer where the drawee or acceptor is not bound as between himself and the drawer, to accept or

pay the bill, and the drawer has no reason to believe that the bill would be paid if presented.

(d) as regards an indorser, where the bill was accepted or made for the accommodation of that indorser, and he has no reason to expect that the bill would be paid if presented.

(e) by waiver of presentment, express or implied.

47. Dishonour by non-payment. (1) A bill is dishonoured by non-payment—

(a) when it is duly presented for payment and payment is refused or cannot be obtained, or

(b) when presentment is excused and the bill is overdue and unpaid.

(2) Subject to the provisions of this Act, when a bill is dishonoured by non-payment, an immediate right of recourse against the drawer and indorsers accrues to the holder.

48. Notice of dishonour and effect of non-notice. Subject to the provisions of this Act, when a bill has been dishonoured by non-acceptance or by non-payment, notice of dishonour must be given to the drawer and each indorser, and any drawer or indorser to whom such notice is not given is discharged: Provided that—

(1) Where a bill is dishonoured by non-acceptance, and notice of dishonour is not given, the rights of a holder in due course, subsequent to the omission, shall not be prejudiced by the omission.

(2) Where a bill is dishonoured by non-acceptance, and due notice of dishonour is given, it shall not be necessary to give notice of a subsequent dishonour by non-payment unless the bill shall in the meantime have been accepted.

49. Rules as to notice of dishonour. Notice of dishonour in order to be valid and effectual must be given in accordance with the following rules—

(1) The notice must be given by or on behalf of the holder, or by or on behalf of an indorser who, at the time of giving it, is himself liable on the bill.

(2) Notice of dishonour may be given by an agent either in his own name, or in the name of any party entitled to give notice whether that party be his principal or not.

(3) Where the notice is given by or on behalf of the holder, it enures for the benefit of all subsequent holders and all prior indorsers who have a right of recourse against the party to whom it is given.

(4) Where notice is given by or on behalf of an indorser entitled to give notice as herein-before provided, it enures for the benefit of the holder and all indorsers subsequent to the party to whom notice is given.

(5) The notice may be given in writing or by personal communication, and may be given in any terms which sufficiently identify the bill, and intimate that the bill has been dishonoured by non-acceptance or non-payment.

(6) The return of a dishonoured bill to the drawer or an indorser is, in point of form, deemed a sufficient notice of dishonour.

(7) A written notice need not be signed, and an insufficient written notice may be supplemented and validated by verbal communication. A misdescription of the bill shall not vitiate the notice unless the party to whom the notice is given is in fact misled thereby.

(8) Where notice of dishonour is required to be given to any person, it may be given either to the party himself, or to his agent in that behalf.

(9) Where the drawer or indorser is dead, and the party giving notice knows it, the notice must be given to a personal representative if such there be, and with the exercise of reasonable diligence he can be found.

(10) Where the drawer or indorser is bankrupt, notice may be given either to the party himself or to the trustee.

(11) Where there are two or more drawers or indorsers who are not partners, notice must be given to each of them, unless one of them has authority to receive such notice for the others.

(12) The notice may be given as soon as the bill is dishonoured and must be given within a reasonable time thereafter.

In the absence of special circumstances notice is not deemed to have been given within a reasonable time, unless—

(a) where the person giving and the person to receive notice reside in the same place, the notice is given or sent off in time to reach the latter on the day after the dishonour of the bill.

(b) where the person giving and the person to receive notice reside in different places, the notice is sent off on the day

after the dishonour of the bill, if there be a post at a convenient hour on that day, and if there be no post on that day then by the next post thereafter.

(13) Where a bill when dishonoured is in the hands of an agent, he may either himself give notice to the parties liable on the bill, or he may give notice to his principal. If he give notice to his principal, he must do so within the same time as if he were the holder, and the principal upon receipt of such notice has himself the same time for giving notice as if the agent had been an independent holder.

(14) Where a party to a bill receives due notice of dishonour, he has after the receipt of such notice the same period of time for giving notice to antecedent parties that the holder has after the dishonour.

(15) Where a notice of dishonour is duly addressed and posted, the sender is deemed to have given due notice of dishonour, notwithstanding any miscarriage by the post office.

50. Excuses for non-notice and delay. (1) Delay in giving notice of dishonour is excused where the delay is caused by circumstances beyond the control of the party giving notice, and not imputable to his default, misconduct, or negligence. When the cause of delay ceases to operate the notice must be given with reasonable diligence.

(2) Notice of dishonour is dispensed with—

(a) when, after the exercise of reasonable diligence, notice as required by this Act cannot be given to or does not reach the drawer or indorser sought to be charged:

(b) by waiver express or implied. Notice of dishonour may be waived before the time of giving notice has arrived, or after the omission to give due notice:

(c) as regards the drawer in the following cases, namely, (i) where drawer and drawee are the same person, (ii) where the drawee is a fictitious person or a person not having capacity to contract, (iii) where the drawer is the person to whom the bill is presented for payment, (iv) where the drawee or acceptor is as between himself and the drawer under no obligation to accept or pay the bill, (v) where the drawer has countermanded payment:

(d) as regards the indorser in the following cases, namely, (i) where the drawee is a fictitious person or a person not having capacity to contract, and the indorser was aware of the fact at the time he indorsed the bill, (ii) where the

indorser is the person to whom the bill is presented for payment, (iii) where the bill was accepted or made for his accommodation.

51. Noting or protest of bill. (1) Where an inland bill has been dishonoured it may, if the holder think fit, be noted for non-acceptance or non-payment, as the case may be; but it shall not be necessary to note or protest any such bill in order to preserve the recourse against the drawer or indorser.

(2) Where a foreign bill, appearing on the face of it to be such, has been dishonoured by non-acceptance it must be duly protested for non-acceptance, and where such a bill, which has not been previously dishonoured by non-acceptance, is dishonoured by non-payment it must be duly protested for non-payment. If it be not so protested the drawer and indorsers are discharged. Where a bill does not appear on the face of it to be a foreign bill, protest thereof in case of dishonour is unnecessary.

(3) A bill which has been protested for non-acceptance may be subsequently protested for non-payment.

(4) Subject to the provisions of this Act, when a bill is noted or protested [it may be noted on the day of its dishonour and must be noted not later than the next succeeding business day]. When a bill has been duly noted, the protest may be subsequently extended as of the date of the noting.

(5) Where the acceptor of a bill becomes bankrupt or insolvent or suspends payment before it matures, the holder may cause the bill to be protested for better security against the drawer and indorsers.

(6) A bill must be protested at the place where it is dishonoured: Provided that—

(a) when a bill is presented through the post office, and returned by post dishonoured, it may be protested at the place to which it is returned and on the day of its return if received during business hours, and if not received during business hours, then not later than the next business day:

(b) when a bill drawn payable at the place of business or residence of some person other than the drawee has been dishonoured by non-acceptance, it must be protested for non-payment at the place where it is expressed to be payable, and no further presentment for payment to, or demand on, the drawee is necessary.

(7) A protest must contain a copy of the bill, and must be signed by the notary making it, and must specify—

(a) the person at whose request the bill is protested:

(b) the place and date of protest, the cause or reason for protesting the bill, the demand made, and the answer given, if any, or the fact that the drawee or acceptor could not be found.

(8) Where a bill is lost or destroyed, or is wrongly detained from the person entitled to hold it, protest may be made on a copy or written particulars thereof.

(9) Protest is dispensed with by any circumstances which would dispense with notice of dishonour. Delay in noting or protesting is excused when the delay is caused by circumstances beyond the control of the holder, and not imputable to his default, misconduct, or negligence. When the cause of delay ceases to operate the bill must be noted or protested with reasonable diligence.

52. Duties of holder as regards drawee or acceptor. (1) When a bill is accepted generally presentment for payment is not necessary in order to render the acceptor liable.

(2) When by the terms of a qualified acceptance presentment for payment is required, the acceptor, in the absence of an express stipulation to that effect, is not discharged by the omission to present the bill for payment on the day that it matures.

(3) In order to render the acceptor of a bill liable it is not necessary to protest it, or that notice of dishonour should be given to him.

(4) Where the holder of a bill presents it for payment, he shall exhibit the bill to the person from whom he demands payment, and when a bill is paid the holder shall forthwith deliver it up to the party paying it.

Liabilities of Parties

53. Funds in hands of drawee. (1) A bill, of itself, does not operate as an assignment of funds in the hands of the drawee available for the payment thereof, and the drawee of a bill who does not accept as required by this Act is not liable on the instrument. This subsection shall not extend to Scotland.

(2) (*Application to Scotland.*)

54. Liability of acceptor. The acceptor of a bill, by accepting it—

(1) Engages that he will pay it according to the tenour of his acceptance:

(2) Is precluded from denying to a holder in due course:

(a) The existence of the drawer, the genuineness of his signature, and his capacity and authority to draw the bill;

(b) In the case of a bill payable to drawer's order, the then capacity of the drawer to indorse, but not the genuineness or validity of his indorsement;

(c) In the case of a bill payable to the order of a third person, the existence of the payee and his then capacity to indorse, but not the genuineness or validity of his indorsement.

55. Liability of drawer or indorser. (1) The drawer of a bill by drawing it—

(a) Engages that on due presentment it shall be accepted and paid according to its tenor, and that if it be dishonoured he will compensate the holder or any indorser who is compelled to pay it, provided that the requisite proceedings on dishonour be duly taken;

(b) Is precluded from denying to a holder in due course the existence of the payee and his then capacity to indorse.

(2) The indorser of a bill by indorsing it—

(a) engages that on due presentment it shall be accepted and paid according to its tenor, and that if it be dishonoured he will compensate the holder or a subsequent indorser who is compelled to pay it, provided that the requisite proceedings on dishonour be duly taken;

(b) is precluded from denying to a holder in due course the genuineness and regularity in all respects of the drawer's signature and all previous indorsements;

(c) is precluded from denying to his immediate or a subsequent indorsee that the bill was at the time of his indorsement a valid and subsisting bill, and that he had then a good title thereto.

56. Stranger signing bill liable as indorser. Where a person signs a bill otherwise than as drawer or acceptor, he thereby incurs the liabilities of an indorser to a holder in due course.

57. Measure of damages against parties to dishonoured bill. Where a bill is dishonoured, the measure of damages, which shall be deemed to be liquidated damages, shall be as follows:

(1) The holder may recover from any party liable on the bill, and the drawer who has been compelled to pay the bill may recover from the acceptor, and an indorser who has been compelled to pay the bill may recover from the acceptor or from the drawer, or from a prior indorser—

(a) the amount of the bill:

(b) interest thereon from the time of presentment for payment if the bill is payable on demand, and from the maturity of the bill in any other case:

(c) the expenses of noting, or, when protest is necessary, and the protest has been extended, the expenses of protest.

(2) In the case of a bill which has been dishonoured abroad, in lieu of the above damages, the holder may recover from the drawer or an indorser, and the drawer or an indorser who has been compelled to pay the bill may recover from any party liable to him, the amount of the re-exchange with interest thereon until the time of payment.

(3) Where by this Act interest may be recovered as damages, such interest may, if justice require it, be withheld wholly or in part, and where a bill is expressed to be payable with interest at a given rate, interest as damages may or may not be given at the same rate as interest proper.

58. Transferor by delivery and transferee. (1) Where the holder of a bill payable to bearer negotiates it by delivery without indorsing it he is called a "transferor by delivery."

(2) A transferor by delivery is not liable on the instrument.

(3) A transferor by delivery who negotiates a bill thereby warrants to his immediate transferee being a holder for value that the bill is what it purports to be, that he has a right to transfer it, and that at the time of transfer he is not aware of any fact which renders it valueless.

Discharge of Bill

59. Payment in due course. (1) A bill is discharged by payment in due course by or on behalf of the drawee or acceptor.

"Payment in due course" means payment made at or after the maturity of the bill to the holder thereof in good faith and without notice that his title to the bill is defective.

(2) Subject to the provisions herein-after contained, when a bill is paid by the drawer or an indorser it is not discharged; but

(a) Where a bill payable to, or to the order of, a third party is paid by the drawer, the drawer may enforce payment thereof against the acceptor, but may not re-issue the bill.

(b) Where a bill is paid by an indorser, or where a bill payable to drawer's order is paid by the drawer, the party paying it is remitted to his former rights as regards the acceptor or antecedent parties, and he may, if he thinks fit, strike out his own subsequent indorsements, and again negotiate the bill.

(3) Where an accommodation bill is paid in due course by the party accommodated the bill is discharged.

60. Banker paying demand draft whereon indorsement is forged. When a bill payable to order on demand is drawn on a banker, and the banker on whom it is drawn pays the bill in good faith and in the ordinary course of business, it is not incumbent on the banker to show that the indorsement of the payee or any subsequent indorsement was made by or under the authority of the person whose indorsement it purports to be, and the banker is deemed to have paid the bill in due course, although such indorsement has been forged or made without authority.

61. Acceptor the holder at maturity. When the acceptor of a bill is or becomes the holder of it at or after its maturity, in his own right, the bill is discharged.

62. Express waiver. (1) When the holder of a bill at or after its maturity absolutely and unconditionally renounces his rights against the acceptor the bill is discharged.

The renunciation must be in writing, unless the bill is delivered up to the acceptor.

(2) The liabilities of any party to a bill may in like manner be renounced by the holder before, at, or after its maturity; but nothing in this section shall affect the rights of a holder in due course without notice of the renunciation.

63. Cancellation. (1) Where a bill is intentionally cancelled by the holder or his agent, and the cancellation is apparent thereon, the bill is discharged.

(2) In like manner any party liable on a bill may be discharged by the intentional cancellation of his signature by the holder or his agent. In

such case any indorser who would have had a right of recourse against the party whose signature is cancelled is also discharged.

(3) A cancellation made unintentionally, or under a mistake, or without the authority of the holder is inoperative; but where a bill or any signature thereon appears to have been cancelled the burden of proof lies on the party who alleges that the cancellation was made unintentionally, or under a mistake, or without authority.

64. Alteration of bill. (1) Where a bill or acceptance is materially altered without the assent of all parties liable on the bill, the bill is avoided except as against a party who has himself made, authorised, or assented to the alteration, and subsequent indorsers. Provided that,

Where a bill has been materially altered, but the alteration is not apparent, and the bill is in the hands of a holder in due course, such holder may avail himself of the bill as if it had not been altered, and may enforce payment of it according to its original tenour.

(2) In particular the following alterations are material, namely, any alteration of the date, the sum payable, the time of payment, the place of payment, and, where a bill has been accepted generally, the addition of a place of payment without the acceptor's assent.

Acceptance and Payment for Honour

65. Acceptance for honour suprà protest. (1) Where a bill of exchange has been protested for dishonour by non-acceptance, or protested for better security, and is not overdue, any person, not being a party already liable thereon, may, with the consent of the holder, intervene and accept the bill *suprà protest* for the honour of any party liable thereon, or for the honour of the person for whose account the bill is drawn.

(2) A bill may be accepted for honour for part only of the sum for which it is drawn.

(3) An acceptance for honour *suprà protest* in order to be valid must—

(a) be written on the bill, and indicate that it is an acceptance for honour:

(b) be signed by the acceptor for honour.

(4) Where an acceptance for honour does not expressly state for whose honour it is made it is deemed to be an acceptance for the honour of the drawer.

(5) Where a bill payable after sight is accepted for honour, its maturity is calculated from the date of the noting for non-acceptance, and not from the date of the acceptance for honour.

66. Liability of acceptor for honour. (1) The acceptor for honour of a bill by accepting it engages that he will, on due presentment, pay the bill according to the tenor of his acceptance, if it is not paid by the drawee, provided it has been duly presented for payment, and protested for non-payment, and that he receives notice of these facts.

(2) The acceptor for honour is liable to the holder and to all parties to the bill subsequent to the party for whose honour he has accepted.

67. Presentment to acceptor for honour. (1) Where a dishonoured bill has been accepted for honour *suprà protest,* or contains a reference in case of need, it must be protested for non-payment before it is presented for payment to the acceptor for honour, or referee in case of need.

(2) Where the address of the acceptor for honour is in the same place where the bill is protested for non-payment, the bill must be presented to him not later than the day following its maturity; and where the address of the acceptor for honour is in some place other than the place where it was protested for non-payment, the bill must be forwarded not later than the day following its maturity for presentment to him.

(3) Delay in presentment or non-presentment is excused by any circumstance which would excuse delay in presentment for payment or non-presentment for payment.

(4) When a bill of exchange is dishonoured by the acceptor for honour it must be protested for non-payment by him.

68. Payment for honour suprà protest. (1) Where a bill has been protested for non-payment, any person may intervene and pay it *suprà protest* for the honour of any party liable thereon, or for the honour of the person for whose account the bill is drawn.

(2) Where two or more persons offer to pay a bill for the honour of different parties, the person whose payment will discharge most parties to the bill shall have the preference.

(3) Payment for honour *suprà protest,* in order to operate as such and not as a mere voluntary payment, must be attested by a notarial act of honour which may be appended to the protest or form an extension of it.

(4) The notarial act of honour must be founded on a declaration made by the payer for honour, or his agent in that behalf, declaring his intention to pay the bill for honour, and for whose honour he pays.

(5) Where a bill has been paid for honour, all parties subsequent to the party for whose honour it is paid are discharged, but the payer for honour is subrogated for, and succeeds to both the rights and duties of, the holder as regards the party for whose honour he pays, and all parties liable to that party.

(6) The payer for honour on paying to the holder the amount of the bill and the notarial expenses incidental to its dishonour is entitled to receive both the bill itself and the protest. If the holder do not on demand deliver them up he shall be liable to the payer for honour in damages.

(7) Where the holder of a bill refuses to receive payment *suprà protest* he shall lose his right of recourse against any party who would have been discharged by such payment.

Lost Instruments

69. Holder's right to duplicate of lost bill. Where a bill has been lost before it is overdue the person who was the holder of it may apply to the drawer to give him another bill of the same tenor, giving security to the drawer if required to indemnify him against all persons whatever in case the bill alleged to have been lost shall be found again.

If the drawer on request as aforesaid refuses to give such duplicate bill he may be compelled to do so.

70. Action on lost bill. In any action or proceeding upon a bill, the court or a judge may order that the loss of the instrument shall not be set up, provided an indemnity be given to the satisfaction of the court or judge against the claims of any other person upon the instrument in question.

Bill in a Set

71. Rules as to sets. (1) Where a bill is drawn in a set, each part of the set being numbered, and containing a reference to the other parts the whole of the parts constitute one bill.

(2) Where the holder of a set indorses two or more parts to different persons, he is liable on every such part, and every indorser subsequent to him is liable on the part he has himself indorsed as if the said parts were separate bills.

(3) Where two or more parts of a set are negotiated to different holders in due course, the holder whose title first accrues is as between such holders deemed the true owner of the bill; but nothing in this subsection shall affect the rights of a person who in due course accepts or pays the part first presented to him.

(4) The acceptance may be written on any part, and it must be written on one part only.

If the drawee accepts more than one part, and such accepted parts get into the hands of different holders in due course, he is liable on every such part as if it were a separate bill.

(5) When the acceptor of a bill drawn in a set pays it without requiring the part bearing his acceptance to be delivered up to him, and that part at maturity is outstanding in the hands of a holder in due course, he is liable to the holder thereof.

(6) Subject to the preceding rules, where any one part of a bill drawn in a set is discharged by payment or otherwise, the whole bill is discharged.

Conflict of Laws

72. Rules where laws conflict. Where a bill drawn in one country is negotiated, accepted, or payable in another, the rights, duties, and liabilities of the parties thereto are determined as follows:

(1) The validity of a bill as regards requisites in form is determined by the law of the place of issue, and the validity as regards requisites in form of the supervening contracts, such as acceptance, or indorsement, or acceptance *suprà protest,* is determined by the law of the place where such contract was made. Provided that,

(a) Where a bill is issued out of the United Kingdom it is not invalid by reason only that it is not stamped in accordance with the law of the place of issue:

(b) Where a bill, issued out of the United Kingdom, conforms, as regards requisites in form, to the law of the United Kingdom, it may, for the purpose of enforcing payment thereof, be treated as valid as between all persons who negotiate, hold, or become parties to it in the United Kingdom.

(2) Subject to the provisions of this Act, the interpretation of the drawing, indorsement, acceptance, or acceptance *suprà protest* of a bill, is determined by the law of the place where such contract is made.

Provided that where an inland bill is indorsed in a foreign country the indorsement shall as regards the payer be interpreted according to the law of the United Kingdom.

(3) The duties of the holder with respect to presentment for acceptance or payment and the necessity for or sufficiency of a protest or

notice of dishonour, or otherwise, are determined by the law of the place where the act is done or the bill is dishonoured.

(4) Where a bill is drawn out of but payable in the United Kingdom and the sum payable is not expressed in the currency of the United Kingdom the amount shall, in the absence of some express stipulation, be calculated according to the rate of exchange for sight drafts at the place of payment on the day the bill is payable.

(5) Where a bill is drawn in one country and is payable in another, the due date thereof is determined according to the law of the place where it is payable.

Part III

Cheques on a Banker

73. Cheque defined. A cheque is a bill of exchange drawn on a banker payable on demand.

Except as otherwise provided in this Part, the provisions of this Act applicable to a bill of exchange payable on demand apply to a cheque.

74. Presentment of cheque for payment. Subject to the provisions of this Act—

(1) Where a cheque is not presented for payment within a reasonable time of its issue, and the drawer or the person on whose account it is drawn had the right at the time of such presentment as between him and the banker to have the cheque paid and suffers actual damage through the delay, he is discharged to the extent of such damage, that is to say, to the extent to which such drawer or person is a creditor of such banker to a larger amount than he would have been had such cheque been paid.

(2) In determining what is a reasonable time regard shall be had to the nature of the instrument, the usage of trade and of bankers, and the facts of the particular case.

(3) The holder of such cheque as to which such drawer or person is discharged shall be a creditor, in lieu of such drawer or person, of such banker to the extent of such discharge, and entitled to recover the amount from him.

74A. Presentment of cheque for payment: alternative place of presentment. Where the banker on whom a cheque is drawn—

(a) has by notice published in the London, Edinburgh and Belfast Gazettes specified an address at which cheques drawn on him may be presented, and

(b) has not by notice so published cancelled the specification of that address, the cheque is also presented at the proper place if it is presented there.

74B. Presentment of cheque for payment: alternative means of presentment by banker. (1) A banker may present a cheque for payment to the banker on whom it is drawn by notifying him of its essential features by electronic means or otherwise, instead of by presenting the cheque itself.

(2) If a cheque is presented for payment under this section, presentment need not be made at the proper place or at a reasonable hour on a business day.

(3) If, before the close of business on the next business day following presentment of a cheque under this section, the banker on whom the cheque is drawn requests the banker by whom the cheque was presented to present the cheque itself—

(a) the presentment under this section shall be disregarded, and

(b) this section shall not apply in relation to the subsequent presentment of the cheque.

(4) A request under subsection (3) above for the presentment of a cheque shall not constitute dishonour of the cheque by non-payment.

(5) Where presentment of a cheque is made under this section, the banker who presented the cheque and the banker on whom it is drawn shall be subject to the same duties in relation to the collection and payment of the cheque as if the cheque itself had been presented for payment.

(6) For the purposes of this section, the essential features of a cheque are—

(a) the serial number of the cheque,

(b) the code which identifies the banker on whom the cheque is drawn,

(c) the account number of the drawer of the cheque, and

(d) the amount of the cheque as entered by the drawer of the cheque.

74C. Cheques presented for payment under section 74B: disapplication of section 52(4). Section 52(4) above—

(a) so far as relating to presenting a bill for payment, shall not apply to presenting a cheque for payment under section 74B above, and

(b) so far as relating to a bill which is paid, shall not apply to a cheque which is paid following presentment under that section.

75. Revocation of banker's authority. The duty and authority of a banker to pay a cheque drawn on him by his customer are determined by—

(1) countermand of payment:

(2) notice of the customer's death.

Crossed Cheques

76. General and special crossings defined. (1) Where a cheque bears across its face an addition of—

(a) the words "and company" or any abbreviation thereof between two parallel transverse lines, either with or without the words "not negotiable"; or

(b) two parallel transverse lines simply, either with or without the words "not negotiable";

that addition constitutes a crossing, and the cheque is crossed generally.

(2) Where a cheque bears across its face an addition of the name of a banker, either with or without the words "not negotiable," that addition constitutes a crossing, and the cheque is crossed specially and to that banker.

77. Crossing by drawer or after issue. (1) A cheque may be crossed generally or specially by the drawer.

(2) Where a cheque is uncrossed, the holder may cross it generally or specially.

(3) Where a cheque is crossed generally the holder may cross it specially.

(4) Where a cheque is crossed generally or specially, the holder may add the words "not negotiable."

(5) Where a cheque is crossed specially, the banker to whom it is crossed may again cross it specially to another banker for collection.

(6) Where an uncrossed cheque, or a cheque crossed generally, is sent to a banker for collection, he may cross it specially to himself.

78. Crossing a material part of cheque. A crossing authorised by this Act is a material part of the cheque; it shall not be lawful for any per-

son to obliterate or, except as authorised by this Act, to add to or alter the crossing.

79. Duties of banker as to crossed cheques. (1) Where a cheque is crossed specially to more than one banker except when crossed to an agent for collection being a banker, the banker on whom it is drawn shall refuse payment thereof.

(2) Where the banker on whom a cheque is drawn which is so crossed nevertheless pays the same, or pays a cheque crossed generally otherwise than to a banker, or if crossed specially otherwise than to the banker to whom it is crossed, or his agent for collection being a banker, he is liable to the true owner of the cheque for any loss he may sustain owing to the cheque having been so paid.

Provided that where a cheque is presented for payment which does not at the time of presentment appear to be crossed, or to have had a crossing which has been obliterated, or to have been added to or altered otherwise than as authorised by this Act, the banker paying the cheque in good faith and without negligence shall not be responsible or incur any liability, nor shall the payment be questioned by reason of the cheque having been crossed, or of the crossing having been obliterated or having been added to or altered otherwise than as authorised by this Act, and of payment having been made otherwise than to a banker or to the banker to whom the cheque is or was crossed, or to his agent for collection being a banker, as the case may be.

80. Protection to banker and drawer where cheque is crossed. Where the banker, on whom a crossed cheque (including a cheque which under section 81A below or otherwise is not transferable) is drawn, in good faith and without negligence pays it, if crossed generally, to a banker, and if crossed specially, to the banker to whom it is crossed, or his agent for collection being a banker, the banker paying the cheque, and, if the cheque has come into the hands of the payee, the drawer, shall respectively be entitled to the same rights and be placed in the same position as if payment of the cheque had been made to the true owner thereof.

81. Effect of crossing on holder. Where a person takes a crossed cheque which bears on it the words "not negotiable," he shall not have and shall not be capable of giving a better title to the cheque than that which the person from whom he took it had.

81A. Non-transferable cheques. (1) Where a cheque is crossed and bears across its face the words "account payee" or "a/c payee," either with or without the word "only," the cheque shall not be transferable, but shall only be valid as between the parties thereto.

(2) A banker is not to be treated for the purposes of section 80 above as having been negligent by reason only of his failure to concern himself with any purported indorsement of a cheque which under subsection (1) above or otherwise is not transferable.

82. Protection to collecting banker. Where a banker in good faith and without negligence receives payment for a customer of a cheque crossed generally or specially to himself, and the customer has no title or a defective title thereto, the banker shall not incur any liability to the true owner of the cheque by reason only of having received such payment.

Part IV

Promissory Notes

83. Promissory note defined. (1) A promissory note is an unconditional promise in writing made by one person to another signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money, to, or to the order of, a specified person or to bearer.

(2) An instrument in the form of a note payable to maker's order is not a note within the meaning of this section unless and until it is indorsed by the maker.

(3) A note is not invalid by reason only that it contains also a pledge of collateral security with authority to sell or dispose thereof.

(4) A note which is, or on the face of it purports to be, both made and payable within the British Islands is an inland note. Any other note is a foreign note.

84. Delivery necessary. A promissory note is inchoate and incomplete until delivery thereof to the payee or bearer.

85. Joint and several notes. (1) A promissory note may be made by two or more makers, and they may be liable thereon jointly, or jointly and severally according to its tenour.

(2) Where a note runs "I promise to pay" and is signed by two or more persons it is deemed to be their joint and several note.

86. Note payable on demand. (1) Where a note payable on demand has been indorsed, it must be presented for payment within a reasonable time of the indorsement. If it be not so presented the indorser is discharged.

(2) In determining what is reasonable time, regard shall be had to the nature of the instrument, the usage of trade, and the facts of the particular case.

(3) Where a note payable on demand is negotiated, it is not deemed to be overdue, for the purpose of affecting the holder with defects of title of which he had no notice, by reason that it appears that a reasonable time for presenting it for payment has elapsed since its issue.

87. Presentment of note for payment. (1) Where a promissory note is in the body of it made payable at a particular place, it must be presented for payment at that place in order to render the maker liable. In any other case, presentment for payment is not necessary in order to render the maker liable.

(2) Presentment for payment is necessary in order to render the indorser of a note liable.

(3) Where a note is in the body of it made payable at a particular place, presentment at that place is necessary in order to render an indorser liable; but when a place of payment is indicated by way of memorandum only, presentment at that place is sufficient to render the indorser liable, but a presentment to the maker elsewhere, if sufficient in other respects, shall also suffice.

88. Liability of maker. The maker of a promissory note by making it—

(1) engages that he will pay it according to its tenour;

(2) is precluded from denying to a holder in due course the existence of the payee and his then capacity to indorse.

89. Application of Part II to notes. (1) Subject to the provisions in this part, and except as by this section provided, the provisions of this Act relating to bills of exchange apply, with the necessary modifications, to promissory notes.

(2) In applying those provisions the maker of a note shall be deemed to correspond with the acceptor of a bill, and the first indorser of a note shall be deemed to correspond with the drawer of an accepted bill payable to drawer's order.

(3) The following provisions as to bills do not apply to notes; namely, provisions relating to

(a) presentment for acceptance;

(b) acceptance;

(c) acceptance *suprà protest*;

(d) bills in a set.

(4) Where a foreign note is dishonoured, protest thereof is unnecessary.

Part V

Supplementary

90. Good faith. A thing is deemed to be done in good faith, within the meaning of this Act, where it is in fact done honestly, whether it is done negligently or not.

91. Signature. (1) Where, by this Act, any instrument or writing is required to be signed by any person it is not necessary that he should sign it with his own hand, but it is sufficient if his signature is written thereon by some other person by or under his authority.

(2) In the case of a corporation, where, by this Act, any instrument or writing is required to be signed, it is sufficient if the instrument or writing be sealed with the corporate seal.

But nothing in this section shall be construed as requiring the bill or note of a corporation to be under seal.

92. Computation of time. Where, by this Act, the time limited for doing any act or thing is less than three days, in reckoning time, non-business days are excluded.

"Non-business days" for the purposes of this Act mean—

(a) Saturday, Sunday, Good Friday, Christmas Day:

(b) A bank holiday under the Banking and Financial Dealings Act 1971:

(c) A day appointed by Royal proclamation as a public fast or thanksgiving day:

(d) A day declared by an order under section 2 of the Banking and Financial Dealings Act 1971 to be a non-business day.

Any other day is a business day.

93. When noting equivalent to protest. For the purposes of this Act, where a bill or note is required to be protested within a specified time or before some further proceeding is taken, it is sufficient that the bill has been noted for protest before the expiration of the specified time or the taking of the proceeding; and the formal protest may be extended at any time thereafter as of the date of the noting.

94. Protest when notary not accessible. Where a dishonoured bill or note is authorised or required to be protested, and the services of a notary cannot be obtained at the place where the bill is dishonoured, any householder or substantial resident of the place may, in the presence of two witnesses, give a certificate, signed by them, attesting the dishon-

our of the bill, and the certificate shall in all respects operate as if it were a formal protest of the bill.

The form given in Schedule I to this Act may be used with necessary modifications, and if used shall be sufficient.

95. Dividend warrants may be crossed. The provisions of this Act as to crossed cheques shall apply to a warrant for payment of dividend.

96. (*Rep. by the S.L.R. Act,* 1898 (c.22).)

97. Savings. (1) The rules in bankruptcy relating to bills of exchange, promissory notes, and cheques, shall continue to apply thereto notwithstanding anything in this Act contained.

(2) The rules of common law including the law merchant, save in so far as they are inconsistent with the express provisions of this Act, shall continue to apply to bills of exchange, promissory notes, and cheques.

(3) Nothing in this Act or in any repeal effected thereby shall affect—

(a) . . . any law or enactment for the time being in force relating to the revenue:

(b) the provisions of the Companies Act, 1862, or Acts amending it, or any Act relating to joint stock banks or companies:

(c) the provisions of any Act relating to or confirming the privileges of the Bank of England or the Bank of Ireland respectively:

(d) the validity of any usage relating to dividend warrants, or the indorsements thereof.

98. (*Application to Scotland.*)

99. Construction with other Acts, etc. Where any Act or document refers to any enactment repealed by this Act, the Act or document shall be construed, and shall operate, as if it referred to the corresponding provisions of this Act.

100. (*Application to Scotland.*)

Schedules

First Schedule

Section 94

Form of protest which may be used when the services of a notary cannot be obtained.

Know all men that I, *A.B.* [householder], of _____ in the county of _____ in the United Kingdom, at the request of *C.D.*, there being no notary public available, did on the _____ day of _____ at_____ demand payment [*or* acceptance] of the bill of exchange hereunder written, from *E.F.*, to which demand he made answer [state answer, if any] wherefore I now, in the presence of *G.H.* and *J.K.* do protest the said bill of exchange.

(Signed) *A.B.*

G.H. witness

J.K. witness

N.B. The bill itself should be annexed, or a copy of the bill and all that is written thereon should be underwritten.

(*Second Schedule Rep. by the S.L.R. Act, 1898 (c.22).*)

Appendix II

4 Central Bank Payment and Settlement Services with Respect to Cross-Border and Multi-Currency Transactions

[Excerpt][1]

2. SUMMARY AND CONCLUSIONS

2.1 Reflecting their different domestic origins, payments systems within the G-10 countries vary considerably. Some systems complete home-currency large-value funds transfer on a gross, payment-by-payment basis, while other systems rely on net settlement procedures. In some countries, final (i.e. irrevocable and unconditional) transfers can be made in "real time" throughout the business day, while other such transfers might not become final until several hours or possibly a day or more after they are initiated. Each country's payments system has its own hours of operation, and these hours typically are not synchronised with payments system operating hours in other countries.

2.2 Using these diverse home-currency payments systems to settle cross-border and multi-currency transactions can be cumbersome and may entail considerable risk. For instance, when the hours of operation of two payments systems do not overlap, it is technically impossible to arrange for the simultaneous settlement of both sides of a foreign exchange transaction. Even when operating hours do overlap, local payments arrangements often make it difficult to control and coordinate the timing of payments in several currencies. More generally, differences and uncertainty in the timing of finality in each country present other obstacles to the effective management of the risks that arise in cross-border and multi-currency settlements.

2.3 Home-currency payments system hours and arrangements and the timing of finality thus make it difficult, if not impossible, to achieve settlements involving two or more currencies (i.e. multi-currency settlements) in which final transfers in one currency

[1]This text is an excerpt from *Central Bank Payment and Settlement Services with Respect to Cross-Border and Multi-Currency Transactions* (September 1993), prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries, Bank for International Settlements.

occur if and only if final transfers in the other currency or currencies also take place. In the absence of such a delivery-versus-payment (DVP) process for settling obligations in multiple currencies, significant credit risks can be present. These risks include the potential loss of principal (often called "principal" or "Herstatt" risk) that would arise if transfers in one currency become final while associated transfers in another currency did not take place. This is a significant risk to international market participants since the loss of principal in settling, for instance, a foreign exchange trade would dwarf any gain or loss that might have accrued to the counterparties to the original transaction.

2.4 Liquidity risks can also arise in the absence of a multi-currency DVP settlement process. For instance, a fear of incurring principal risk might lead some market participants to refuse to honour their obligations in earlier-settling currencies out of concern that a "suspect" counterparty would not be able to settle its associated obligations in later-settling currencies. The sudden interruption of a significant level of expected payment flows could cause serious liquidity problems for the counterparty and, hence, for other market participants that expect to receive payments from the counterparty. This liquidity risk might also spread to other payments systems in the same or other countries if concern about loss of principal during the settlement process became widespread.

Summary of options

2.5 The Working Group examined a range of central bank payment and settlement services that might reduce these risks and increase the efficiency of cross-border and multi-currency settlements. The options that were considered by the Working Group included: (1) modifying or making available certain home-currency payment and settlement services; (2) extending the operating hours of home-currency large-value funds transfer systems; (3) establishing cross-border operational links between these payment systems; and (4) developing multi-currency payment and settlement services. These central bank service options were evaluated in circumstances where they would facilitate the settlement both of individual transactions and of a stream of transactions between two or more counterparties that have been netted through the operation of a private sector netting scheme.

2.6 **Home-currency payment and settlement services.** Certain home-currency payment and settlement services might be modified or made available to increase the level of support for interna-

tional settlements. In particular, where they do not currently exist, settlement accounts and intraday final transfer capabilities could be made available by central banks to settle home-currency obligations related to cross-border and multi-currency transactions. An intraday final transfer capability is defined as the ability to initiate—and to receive timely confirmation of—transfers between accounts at the central bank of issue that become final within a brief period of time. It is important to recognise that the availability of these services would not be sufficient to permit the simultaneous settlement of obligations in all currencies. Hence these home-currency services could not, per se, eliminate the credit and liquidity risks that exist in the absence of multi-currency DVP capabilities.

2.7 Recognising that they cannot eliminate the risks associated with non-DVP settlement, intraday final transfers and settlement accounts nonetheless significantly improve the ability of market participants to manage and control these and other settlement risks. Accurate information about when obligations in each currency are finally discharged would enable individual institutions and clearing houses to quantify and control more precisely and efficiently than they can at present the level and duration of exposures that may be incurred in the process of settling both individual and netted transactions in two or more currencies. It is apparent that the capability in each country's domestic large-value payments system to effect final transfers at any time of the business day between accounts at the central bank of issue is the foundation stone upon which risk reduction measures can be developed in respect of a range of domestic and cross-border transactions.

2.8 **Operating hours of home-currency payments systems.** The operating hours of home-currency large-value funds transfer systems could be extended to increase the level of support for international settlements. At one end of the range of possibilities, a modest lengthening of the operating hours of an individual payments system would reduce its current gap (or increase its current overlap) with the operating hours of payments systems in other countries. Towards the other end of the spectrum (which, in the extreme, could involve the large-value funds transfer systems in a number of countries operating round-the-clock), a major extension of the hours of several key home-currency payments systems could result in an operational overlap of most major currencies. Combined with the availability of final transfers over those systems, such an overlap could create the technical ability to conduct on the same value date a DVP settlement of all relevant currencies

in which counterparties would be assured that payments in one currency would be made if and only if payments in all relevant currencies are made. This would help support the potential elimination of the credit and liquidity risks associated with the current lack of multi-currency DVP capabilities. However, without directly linking payments made over different large-value funds transfer systems, this assurance would have to come from private sector procedures that would use the available home-currency payment and settlement services during the extended hours of operation.

2.9 **Cross-border links between payments systems.** Another possible option might be the establishment of bilateral or multilateral cross-border links between large-value funds transfer systems in conjunction, where necessary, with an extension of their operating hours to increase the level of support for international settlements. In particular, direct operational and informational links could be created that would give participating central banks the joint capability to monitor, control and execute simultaneously final transfers over their respective home-currency payments systems. With such cross-border connections, central banks could directly provide the private sector with DVP settlement services for currencies with overlapping payments system operating hours.

2.10 **Multi-currency payment and settlement services.** Another possible option might involve the joint offering of multi-currency payment and settlement services. Multi-currency accounts and settlement facilities might be provided by the central banks of issue through a "common agent". Specifically, a central bank controlled common agent could accept deposits in multiple currencies and facilitate final transfers between these accounts. A variant of this arrangement would involve one or more central banks acting as the common agent in providing multi-currency services. In both cases, an important issue is whether arrangements would be in place to provide assurances that sufficient liquidity would be available to complete settlement in the relevant currencies.

2.11 The purpose of jointly offering multi-currency services would be similar to that of creating an overlap in the operating hours (with or without direct operational and informational links) of the major large-value funds transfer systems: to provide the private sector with the technical ability to achieve DVP in the settlement of multi-currency obligations. With multi-currency services this would be accomplished by effecting settlement over operational accounts in each currency held either at the common agent or, in the case of the variant discussed above, at one or more individual central banks.

Appendix II

5 Settlement Risk in Foreign Exchange Transactions

[Excerpt][1]

1. EXECUTIVE SUMMARY

1.1 Introduction

The Governors of the central banks of the Group of Ten (G-10) industrial countries have endorsed a comprehensive strategy under which the private and public sectors can together seek to contain the systemic risk inherent in current arrangements for settling foreign exchange transactions. This report, prepared by the Committee on Payment and Settlement Systems (CPSS) of the central banks of the G-10 countries, describes the strategy and presents its underlying analysis.

1.1.1 Central bank concerns

The vast size of daily foreign exchange (FX) trading, combined with the global interdependencies of FX market and payments system participants, raises significant concerns regarding the risk stemming from the current arrangements for settling FX trades. These concerns include the effects on the safety and soundness of banks, the adequacy of market liquidity, market efficiency and overall financial stability.

The risk to domestic payments systems, and to the international financial system, posed by the FX settlement process came into focus at the time of the 1974 failure of Bankhaus Herstatt. More recent examples include Drexel, BCCI, the attempted Soviet coup d'état and Barings.

1.1.2 G-10 initiatives to address concerns

In response to the Herstatt episode, the G-10 central banks began by working together on supervisory issues, including FX market risk and the need for an international early warning system. In the early 1980s, they began to study the payments systems used for the settlement of domestic and cross-border transactions, with a view to ensuring that the structures and designs of those systems did not create unacceptable interbank cred-

[1]This text is an excerpt from *Settlement Risk in Foreign Exchange Transactions* (March 1996), prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries.

it exposures and did not generate liquidity risks for the financial markets or for the national or international banking systems. It was in particular apparent that large-value cross-border payments, including those made in settlement of FX transactions, account for a large, and sometimes very large, proportion of flows through domestic payments systems, and this was seen to require detailed analysis.

The work of the G-10 central banks on international payment arrangements has produced several studies, including the February 1989 *Report on Netting Schemes* (the Angell Report), the November 1990 *Report of the Committee on Interbank Netting Schemes* (the Lamfalussy Report) and the September 1993 report on *Central Bank Payment and Settlement Services with respect to Cross-Border and Multi-Currency Transactions* (the Noël Report). Through these studies the central banks identified issues that may be raised by cross-border and multi-currency netting arrangements, recommended minimum standards and an oversight regime for cross-border netting schemes, and examined possible central bank service options that might decrease risk in the settlement of FX trades.

In June 1994 the CPSS formed the Steering Group on Settlement Risk in Foreign Exchange Transactions to build upon this past work and to develop a strategy for reducing FX settlement risk. In preparing its report, the Steering Group developed a definition and methodology for measuring FX settlement exposure. . . . Using this analytical framework, the Steering Group surveyed approximately 80 banks in the G-10 countries to document current market practices for, and barriers to, managing settlement risks in a prudent manner. This work yielded the following key findings:

- FX settlement exposure is not just an intraday phenomenon: current FX settlement practices create interbank exposures that can last, at a minimum, one to two business days, and it can take a further one to two business days for banks to know with certainty that they received the currency they bought.
- Given current practices, a bank's maximum FX settlement exposure could equal, or even surpass, the amount receivable for three days' worth of trades, so that at any point in time—including weekends and public holidays—the amount at risk to even a single counterparty could exceed a bank's capital.
- Individual banks could, if they so choose, significantly reduce their own exposures and systemic risk more broadly by improving their back office payments processing, correspondent banking arrangements, obligation netting capabilities and risk management controls.
- Well-designed multi-currency services such as multi-currency settlement mechanisms and bilateral and multilateral obligation netting

arrangements could greatly enhance the efforts of individual banks to reduce their FX settlement exposures.

- Some major banks are concerned about the sizable FX settlement risks they face and are actively pursuing ways to improve their own settlement practices and to collectively develop risk-reducing multi-currency services.
- Nevertheless, despite their considerable capacity to reduce FX settlement risk through individual and collective action, many banks remain sceptical about devoting significant resources to such efforts.

1.2 Summary of strategy

Overall, the G-10 central banks believe that private sector institutions have the ability, through individual and collective action, to significantly reduce the systemic risks associated with FX settlements. Accordingly, the Governors of the G-10 central banks have agreed that the following three-track strategy should be implemented:

- **Action by individual banks to control their foreign exchange settlement exposures**

Individual banks should take immediate steps to apply an appropriate credit control process to their FX settlement exposures. This recognises the considerable scope for individual banks to address the problem by improving their current practices for measuring and managing their FX settlement exposures.

- **Action by industry groups to provide risk-reducing multi-currency services**

Industry groups are encouraged to develop well-constructed multi-currency services that would contribute to the risk reduction efforts of individual banks. This recognises the significant potential benefits of multi-currency settlement mechanisms and bilateral and multilateral obligation netting arrangements, and the G-10 central banks' view that such services would best be provided by the private sector rather than the public sector.

- **Action by central banks to induce rapid private sector progress**

Each central bank, in cooperation, where appropriate, with the relevant supervisory authorities, will choose the most effective steps to foster satisfactory private sector action over the next two years in its domestic market. In addition, where appropriate and feasible, central banks will make or seek to achieve certain key enhancements to national payments systems and will consider other steps to facilitate private sector risk reduction efforts. This recognises the likely need for public authorities to encour-

age action by individual banks and industry groups, and to cooperate with these groups, to bring about timely, market-wide progress.

The G-10 central banks believe that this strategy can adequately address the systemic risk inherent in current practices for settling FX transactions. Indeed, several important industry initiatives are well under way. For instance, in 1994 the New York Foreign Exchange Committee issued a report and a set of recommendations designed to help market participants reduce their FX settlement exposures. . . . That report, and the general topic of FX settlement risk, have since received considerable attention. In addition, . . . several risk-reducing multi-currency services are currently available in the market. These include bilateral obligation netting arrangements provided by FXNET, S.W.I.F.T. and VALUNET, and multilateral obligation netting and settlement services provided by ECHO and, prospectively, the proposed Multinet International Bank. Furthermore, the recently formed "Group of 20" banks and other private sector organisations are exploring the feasibility of establishing other multi-currency settlement services. The G-10 central banks for their part stand ready to cooperate, where appropriate and feasible, with all industry groups seeking to develop risk-reducing multi-currency settlement services.

Although any or all of these private sector efforts could play a major role in improving the current situation, they have yet to bring about a substantial and permanent reduction in FX settlement risk throughout the market. Accordingly, the G-10 central banks will closely monitor the progress of private sector action over the next two years to determine the need for further action.

Appendix II

6 Reducing Foreign Exchange Settlement Risk

[Excerpt][1]

III. RECOMMENDATIONS FOR PRIVATE-SECTOR BEST PRACTICES

The sixteen best practices cited below fall into four categories: internal procedures, netting, credit risk management, and crisis management. Many of the best practices can be easily implemented; others may entail expensive or complicated changes in back office operations and systems technology. While many of the best practices can be implemented by the firm internally, others require the cooperation of the firm's correspondent or counterparty. Several of the recommended practices are presently being followed in some parts of the industry. Most of the banks that participated in the Committee's study have implemented at least some of these practices.

The Committee urges market participants to review their own methods of quantifying and controlling settlement risk and to adopt the designated best practices in their operations, credit controls, and crisis management procedures.

Improve Internal Procedures and Correspondent Bank Services to Reduce Settlement Exposures

Together, improving internal procedures and obtaining the best available correspondent bank services have been shown to have the greatest impact in reducing settlement exposure. Because internal procedures are wholly within the control of the individual firm, an evaluation of current operational procedures and their impact on settlement exposure is recommended as the first step to reducing settlement risk. Similarly, services rendered by a firm's correspondent banks are critical in their impact on settlement risk. Accordingly, firms should seek the highest level of correspondent services available.

[1]This text is reproduced with permission from The New York Foreign Exchange Committee. It is an excerpt from The New York Foreign Exchange Committee, *Reducing Foreign Exchange Settlement Risk* 23–32 (October 1994).

Recommendation No. 1 Understand the settlement process

Senior management should promote a complete understanding of the settlement process at all decision-making levels.

To improve internal procedures and controls, decision-makers at all levels, from operations and administrative personnel to credit and senior management, should understand the settlement process fully. Knowledge of when payment instructions are made, when they become irrevocable, and when confirmation of counterparty payment is received with finality is key to determining both the duration and the value of foreign exchange settlement exposure.

Recommendation No. 2 Understand settlement exposure

Credit and risk managers should understand the impact of their internal procedures on settlement exposure and develop accurate methods of quantifying the extent of their risk.

Once a firm has released payment in one currency, its settlement risk with a counterparty is 100 percent of the full amount it expects to receive in another. At a minimum, the full amount is at risk for those hours between the actual payment of currency and the firm's receipt of final funds. More significantly, the period of potential exposure extends from the time that payment instructions become irrevocable until the firm knows that payment has been received. *The timing of the settlement process can extend the period of settlement risk on a single day's transactions from several hours to one or more days.* For example, if irrevocable instructions for tomorrow's payments have been sent out before the firm has reconciled today's receipts, the value of settlement exposure will increase to the total of two days' expected receipts. As a first step in reducing risk, therefore, credit and risk management personnel must understand and accurately measure the extent of their firm's settlement exposure.

Recommendation No. 3 Review and upgrade correspondent services

The bank relations department should review the firm's correspondent bank relationships to ensure that the services provided give the firm maximum control over its nostro account. Emphasis should be placed on obtaining the latest possible cutoff times for cancellation and amendment of payment instructions and the earliest possible confirmation of final receipt.

Historically, many firms have based their choice of correspondent on relationship considerations, attaching less importance to the quality of settlement services provided. Bank relations management should shift

that emphasis toward selecting the correspondent that can provide the highest level of services available. Bank relations personnel need to be aware of the cutoff times imposed by their correspondents on receipt of payment instructions, cancellations, and amendments, and they need to know how quickly a correspondent can provide notification of final receipts.

The Committee's survey results and discussions with providers of correspondent services suggest that, firms have usually been able to negotiate more favorable terms in more recently established correspondent relationships than exist in their longer standing relationships. Bank relations personnel should, therefore, review existing correspondent bank terms on a regular basis and negotiate improvements where necessary.

a. Cutoff times for cancellations/amendments

A correspondent bank should provide the latest possible cutoff time for a firm to cancel or amend payment instructions *with same day effect.* Correspondent banks should distinguish cutoff times for cancellations that can be effected before funds have left their control (in other words, before instructions have been submitted to the payments system) from cutoff times for cancellations that are done after. The distinction is important: in the first case, counterparty exposure is avoided, but in the second case, it is not. A cancellation after payment has already been processed in the payments system may require the consent of the beneficiary or receiving bank, and the return of funds typically occurs on the following business day. For this reason correspondents' cutoff times for same-day cancellations usually fall some time before the opening of the payments system. Correspondents may also offer different cutoff times for cancellations of "book-entry" transfers (i.e., payments requiring only an internal transfer of funds to the recipient's account with the correspondent). These times may be earlier or later, depending on the individual correspondent's practices.

If the cutoff time for cancellation or amendment has passed, but payment has not yet been released, the correspondent bank may attempt to cancel or amend the instructions on a best efforts basis. Many times, a correspondent bank can cancel payment instructions after the cutoff time, but because it cannot guarantee a cancellation with 100 percent certainty, it sets a very early formal cutoff time. Firms should be aware of the distinctions in cutoff times and the additional management capability, particularly in crisis situations, that best efforts services may impart.

A firm that negotiates with the correspondent bank for cutoff times as close to the opening of the payments system as possible and for the latest

possible cutoff times for book-entry transfers will have the greatest flexibility in managing crisis situations. All cutoff times should be confirmed in writing by the correspondent bank. Finally, firms should maintain high-level personal contacts at the correspondent bank and have access to correspondent bank personnel 24 hours a day in crisis situations.

b. Intra-day notification of receipts

Correspondent banks should be able to provide intra-day notice of receipt and to send account statements as soon after finality of the relevant currency as possible. With the proper systems interface, intra-day notices may be used to reconcile payments and receipts on the value date. When the currency is settled through a gross real-time transfer system with intra-day finality, reconciliation can actually be done throughout the day. In a net payments system, reconciliation can begin earlier in the day but can only be done with complete assurance upon finality in the payments system.

Recommendation No. 4 Complete reconciliation as early as possible

Creating the system support necessary to process intra-day notification of receipts and to begin the reconciliation process before the end of the day is an investment that will significantly reduce the amount of time that the total settlement receivable due from each counterparty must be considered at risk.

If reconciliation is completed by the close of the currency's payments system, operations personnel can identify problems much earlier and prevent the release of additional payments if necessary. Automated reconciliation systems should be in place to take advantage of electronic bank statements so that the debit/credit matching process can begin as soon as possible against the firm's own internal records. Exception reports should be available as quickly as possible for investigation.

Recommendation No. 5 Monitor non-receipts and establish and practice clear follow-up procedures

Senior management should establish procedures to evaluate non-receipts of payments and to alert all concerned parties to potential problem situations.

An ongoing dialogue should exist between operations, risk management, trading and sales, and credit to identify potential problem situations as early as possible. Non-receipts should be prioritized using counterparty credit ratings, payment amount and currency, or an internally generated counterparty watch list. The reporting of fails, like the reporting of excesses, should follow standard protocols. In the event that

a fail is not an isolated incident, clear problem management procedures should come into play; all outstanding trades should be reviewed, and consideration given to stopping all new activity. Information heard in the market should be communicated from sales and trading to credit and management. The legal department should be notified of any fails that are not resolved through the regular investigation process.

The effectiveness of each of the controls discussed above is dependent upon the settlement operations and the communications and technical capabilities of the firm and its correspondent banks. Firms and their correspondents will need to weigh the costs of upgrading their settlement procedures and information flows against the long-term benefits. Senior management should make the necessary investment to ensure that the reconciliation process is completed as soon as possible.

Institute Payment Netting to Reduce Settlement Risk

Recommendation No. 6 Establish netting arrangements

Payment netting arrangements should be established with market participants to reduce settlement risk.

Well documented netting of payments (settling net currency amounts on value date rather than settling transactions individually) can dramatically reduce settlement risk in the foreign exchange market. The Committee's analysis demonstrates that netting payments can reduce settlement exposure substantially. Netting is most effective in reducing exposure when the counterparties to a transaction actively trade on both sides of the market.

Firms must ensure to the best of their ability that all netting arrangements are supported by agreements that are legally enforceable in all jurisdictions where the arrangements will be operative.

However, senior management should understand that the *legal framework of an executed agreement does not by itself reduce settlement risk in the underlying transaction.* The driving force behind agreements such as the IFEMA (International Foreign Exchange Master Agreement) or other netting agreements has been for the bankruptcy close-out provisions required under FAS 105 for netting balance sheet reportables. These bilateral agreements also allow firms to comply with the amended Basle Accord for recognition of netting benefits for calculation of capital requirements. A number of firms are executing netting agreements but *not* physically netting settlements with the parties to those agreements. Greater risk reduction is offered by an agreement mandating that parties both net payments and provide close-out netting.

Recommendation No. 7 Establish operational capability to net payments

Management should develop the operational capability to net payments.

Firms often resist netting on the grounds that it requires expensive and complex changes in systems technology. Firms might consider purchasing one of the commercially available netting systems as an alternative to upgrading existing in-house systems. In either case, initial investments in technology and operational training are returned in cost savings over a very short period of time. Dealers who net settlements with their major counterparties report significant operational cost savings not only because fewer payments are processed, but also because clear procedures for confirming and matching netted transactions result in fewer errors. Clearly, in the event of a non-receipt due to counterparty default, a netted amount due in all likelihood represents a significantly smaller loss than would otherwise have been suffered.

Formally documented, netting of payments is the most significant means of reducing routine settlement exposure among active participants in the foreign exchange market. Netting of payments enables market participants not only to reduce settlement volumes and risk, but also to realize substantial operational cost savings over time. The differences in size between settlement losses and pre-settlement close-out losses can be large. While documentation alone can give a firm the right to net pre-settlement gains and losses in the event of a counterparty default, reduction of settlement risk must additionally be addressed in actual practice.

Promote Sound Settlement Risk Management Practices

Recommendation No. 8 Make credit risk managers responsible for monitoring and controlling settlement exposure

Credit risk managers stationed on the trading floor should have primary responsibility for the monitoring and control of foreign exchange counterparty exposure.

Credit risk managers should have a thorough understanding of foreign exchange trading, including operations and settlement procedures, and associated pre-settlement and settlement risk. They should understand the various means available to mitigate or eliminate those risks and be familiar with the credit and legal issues addressed in netting agreements and other supporting documentation.

Responsibility for the day-to-day monitoring of counterparty exposure and compliance with credit limits falls to credit managers. They

should ensure that settlements exceeding approved limits are addressed appropriately, either by obtaining the credit department's approval to settle excesses or by taking action to reduce exposure. They should also monitor trends in credit line use in order to identify repeated over-limit settlements. Credit risk managers should be apprised of all payment fails and respond directly to those requiring immediate management attention.

Another function of the credit risk manager is to oversee any measures necessary to reduce settlement exposure. To reduce exposure, counterparties may agree to roll trades out to settle on a different value date, close out positions by doing an offsetting transaction, or settle trades on a delivery-versus-payment basis (i.e., require the counterparty to deliver the currency bought before paying out the currency sold). Because such measures can involve changes to funding requirements and payments instructions and may entail interest compensation, the credit risk manager should keep the traders and operations personnel informed of these activities. If a counterparty refuses a request to reduce settlement exposure, credit risk managers should join with senior management in negotiating a resolution.

Credit risk managers should encourage ongoing dialogue between trading, sales, operations, credit, and management to ensure that information heard in the market is conveyed to credit and senior management and that the concerns of credit and management are being conveyed to trading, sales, and operations personnel.

Recommendation No. 9 Set prudent settlement exposure limits

The credit department, functioning autonomously from the trading and sales areas, should set settlement exposure limits for all counterparties regardless of size.

Limits should be based on the creditworthiness of the counterparty and should conform to the firm's guidelines on counterparty exposure. Follow-up reviews of existing counterparty relationships should be conducted regularly at prudent intervals.

Settlement limits should be applied to the full value of all currencies due from a counterparty but not confirmed paid with finality. If a firm irrevocably issues a given day's payment instructions before receipts from the preceding day or days have been reconciled, the amount of settlement exposure should include not just that day's expected receipts but all unconfirmed and non-final (provisional) amounts from preceding days as well.

Recommendation No. 10 Update exposures on-line and aggregate exposure globally across all dealing centers

When a firm has dealing centers located in different time zones, counterparty exposure should be monitored in real time and aggregated globally across the firm's dealing centers and the various trading locations of the counterparty.

Without on-line reporting capability, a trader in one time zone who has very limited knowledge of what dealing centers in earlier time zones have transacted with the counterparty will be unable to assess counterparty exposure and line usage in a timely manner. However, the Committee does recognize that it may be difficult to switch to an on-line system immediately because of cost considerations.

Alternatively, in the absence of global monitoring capability, credit risk managers should make allocations of lines for each of their dealing centers. This means of setting limits is less efficient than on-line global monitoring, however, because manual intervention is often required to reallocate line availability from one center to another on the basis of need.

Settlement positions should also be monitored not only for the spot date, but for each future date so that if exposure is unacceptably high, there is sufficient time to arrange to reduce it. The potential settlement exposure value should also be projected for all over-the-counter options on foreign exchange, regardless of whether the option is presently in the money.

A firm should have clear procedures in place for communicating limit violations to the appropriate areas. These procedures should include the communication of all overages to the credit department for approval to settle and the notification of senior management when unacceptably high levels of exposure require remedial action.

Recommendation No. 11 Enforce adherence to settlement limits

The credit department should ensure that traders have up-to-date information on counterparty limits and exposure before they execute a trade.

Traders should adhere to settlement limits, unless they have obtained prior permission from the credit department to exceed them. Procedures should be in place to ensure a rapid response by credit officers to requests to exceed limits on a one-off basis or increase limits on a permanent basis. Similarly, credit officers should clearly communicate to the traders and sales staff when over-limit settlement exposure with a counterparty will not be tolerated. The importance of this two-way commu-

nication must be emphasized. Taking exposure-reducing measures without the agreement of the counterparty can compromise the counterparty relationship or create other, more serious problems. At the same time, of course, the firm must recognize that withholding payment may cause liquidity problems for the counterparty and impede its ability to meet other obligations.

Recommendation No. 12 Mandate ownership of credit risk

Senior management policy should clearly indicate which area takes responsibility for losses stemming from counterparty failure.

Management may choose to allocate the losses resulting from a counterparty default directly to the area responsible for approving or controlling the exposure or to the trading or sales group responsible for maintaining the counterparty relationship. Losses directly attributable to an overlimit or unauthorized trade should be debited directly to the profit and loss of the trader responsible. However, if management chooses to allocate credit losses, its policy should be clearly defined and communicated to all personnel *before* a loss occurs.

Establish Contingency Plans for Crisis Management

Crisis situations can be either systemic or counterparty related. Systemic problems include technical failure, settlement system breakdown, settling agent failure, and force majeure. Counterparty situations include insolvency, repudiation of trades, liquidity problems, and large-scale operational failure.

In crisis situations of any kind, a firm must be sensitive to the potential ramifications of risk-reducing actions. A firm's decision to withhold a settlement payment from a counterparty could create liquidity problems for a single counterparty or in the payment system itself, setting off a domino effect that ultimately affects many participants. As events in the financial markets have demonstrated in recent years, the reaction of the market to a perceived crisis may actually exacerbate the situation.

Recommendation No. 13 Prepare for crisis situations

Firms should anticipate crises and prepare internally.

Each firm should assemble a crisis management team headed by a member of senior management and composed of credit, risk management, and operations personnel. The team should simulate different crisis situations to identify weaknesses in internal communication and to

practice a coordinated response. The team should know how and at what level to communicate effectively with other institutions, correspondent banks, regulators, and central banks.

Recommendation No. 14 Utilize all correspondent capabilities

The quality of services provided by a firm's correspondents should be proved well in advance of a crisis.

During a crisis, a correspondent's capabilities become critical to the firm's management of its settlement exposures. The firm should identify those individuals at its correspondent who can provide support off-hours, and most important, the individual who can accomplish the most within the operating constraints of both the correspondent and the payment system.

Recommendation No. 15 Involve senior management

Senior management should be apprised of a crisis situation at the outset and directly involved in controlling it.

The potential repercussions of major settlement failures require that senior management be directly involved in seeking a resolution. Much can be done at the senior level to verify news heard in the market or to coordinate a concerted response to a crisis situation by the industry.

Recommendation No. 16 Establish industry working groups

At the industry level, working committees should be formed to study the dynamics of crisis situations.

Representation should include senior managers of the major market participants, correspondent agents, and payment service providers. The committee would explore coordinated responses to crises that would minimize disruption to the market, avert liquidity squeezes, and preserve the integrity of the markets.

These groups should study past crises and their resolutions. Their goal should be to recommend or develop methods by which market participants can protect themselves at the same time they avoid exacerbating liquidity problems and disruption to the market.

Appendix III
Materials on Financial Institution Supervision

Appendix III

1 Basle Committee on Banking Supervision's Core Principles for Effective Banking Supervision

[Excerpt][1]

SECTION I: INTRODUCTION

Effective supervision of banking organisations is an essential component of a strong economic environment in that the banking system plays a central role in making payments and mobilising and distributing savings. The task of supervision is to ensure that banks operate in a safe and sound manner and that they hold capital and reserves sufficient to support the risks that arise in their business. Strong and effective banking supervision provides a public good that may not be fully provided in the marketplace and, along with effective macroeconomic policy, is critical to financial stability in any country. While the cost of banking supervision is indeed high, the cost of poor supervision has proved to be even higher.

In drawing up these core principles for effective banking supervision the following precepts are fundamental:

- the key objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors;
- supervisors should encourage and pursue market discipline by encouraging good corporate governance (through an appropriate structure and set of responsibilities for a bank's board of directors and senior management[2] and enhancing market transparency and surveillance;

[1]This text is reproduced with permission from the Basle Committee on Banking Supervision. It is an excerpt from Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (September 1997).

[2]This document refers to a management structure composed of a board of directors and senior management. The Committee is aware that there are significant differences in legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. In some countries, the board has the main, if not exclusive, function of supervising the executive body (senior management, general management) so as to ensure that the latter fulfils its tasks. For this reason, in some cases, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence in that it lays down the general framework for the management of the bank. Owing to these differences, the notions of the board of directors and the senior management are used in this document not to identify legal constructs but rather to label two decision-making functions within a bank.

- in order to carry out its tasks effectively, a supervisor must have operational independence, the means and powers to gather information both on and off site, and the authority to enforce its decisions;
- supervisors must understand the nature of the business undertaken by banks and ensure to the extent possible that the risks incurred by banks are being adequately managed;
- effective banking supervision requires that the risk profile of individual banks be assessed and supervisory resources allocated accordingly;
- supervisors must ensure that banks have resources appropriate to undertake risks, including adequate capital, sound management, and effective control systems and accounting records; and
- close cooperation with other supervisors is essential, particularly where the operations of banking organisations cross national boundaries.

Banking supervision should foster an efficient and competitive banking system that is responsive to the public's need for good quality financial services at a reasonable cost. Generally, it should be recognised that there is a trade-off between the level of protection that supervision provides and the cost of financial intermediation. The lower the tolerance of risk to banks and the financial system, the more intrusive and costly supervision is likely to be, eventually having an adverse effect on innovation and resource allocation.

Supervision cannot, and should not, provide an assurance that banks will not fail. In a market economy, failures are a part of risk-taking. The way in which failures are handled, and their costs borne, is in large part a political matter involving decisions on whether, and the extent to which, public funds should be committed to supporting the banking system. Such matters cannot therefore always be entirely the responsibility of banking supervisors; however, supervisors should have in place adequate arrangements for resolving problem bank situations.

There are certain infrastructure elements that are required to support effective supervision. Where such elements do not exist, supervisors should seek to persuade government to put them in place (and may have a role in designing and developing them). . . .

In some countries responsibility for licensing banks is separate from the process of ongoing supervision. It is clearly essential that, wherever the responsibility lies, the licensing process establishes the same high standards as the process of ongoing supervision which is the main focus of this paper. . . .

The core principles of banking supervision . . . will provide the foundation necessary to achieve a sound supervisory system. Local characteristics will need to be taken into account in the specific way in which these standards are implemented. These standards are necessary but may not be sufficient, on their own, in all situations. Supervisory systems should take into account the nature of and risks involved in the local banking market as well as more generally the local infrastructure. Each country should therefore consider to what extent it needs to supplement these standards with additional requirements to address particular risks and general conditions prevailing in its own market. Furthermore, banking supervision is a dynamic function that needs to respond to changes in the marketplace. Consequently supervisors must be prepared to reassess periodically their supervisory policies and practices in the light of new trends or developments. A sufficiently flexible legislative framework is necessary to enable them to do this.

SECTION II: PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION

Banking supervision is only part of wider arrangements that are needed to promote stability in financial markets. These arrangements include:

1. sound and sustainable macro-economic policies;
2. a well-developed public infrastructure;
3. effective market discipline;
4. procedures for efficient resolution of problems in banks; and
5. mechanisms for providing an appropriate level of systemic protection (or public safety net).

1. *Providing sound and sustainable macro-economic policies* are not within the competence of banking supervisors. Supervisors, however, will need to react if they perceive that existing policies are undermining the safety and soundness of the banking system. In the absence of sound macro-economic policies, banking supervisors will be faced with a virtually impossible task. Therefore, sound macro-economic policies must be the foundation of a stable financial system.

2. *A well-developed public infrastructure* needs to cover the following facilities, which, if not adequately provided, can significantly contribute to the destabilisation of financial systems:

- a system of business laws including corporate, bankruptcy, contract, consumer protection and private property laws, that is consistently enforced and provides a mechanism for fair resolution of disputes;

- comprehensive and well-defined accounting principles and rules that command wide international acceptance;
- a system of independent audits for companies of significant size so that users of financial statements, including banks, have independent assurance that the accounts provide a true and fair view of the financial position of the company and are prepared according to established accounting principles, with auditors held accountable for their work;
- effective banking supervision (as outlined in this document);
- well-defined rules governing, and adequate supervision of, other financial markets and, where appropriate, their participants; and,
- a secure and efficient payment and clearing system for the settlement of financial transactions where counterparty risks are controlled.

3. *Effective market discipline* depends on an adequate flow of information to market participants, appropriate financial incentives to reward well managed institutions and arrangements that ensure that investors are not insulated from the consequences of their decisions. Among the issues to be addressed are corporate governance and ensuring that accurate, meaningful, transparent and timely information is provided by borrowers to investors and creditors.

Market signals can be distorted and discipline undermined if governments seek to influence or override commercial decisions, particularly lending decisions, to achieve public policy objectives. In these circumstances, it is important that if guarantees are provided for such lending, they are disclosed and arrangements are made to compensate financial institutions when policy loans cease to perform.

4. Sufficiently flexible powers are necessary in order to effect an *efficient resolution of problems in banks.* Where problems are remediable, supervisors will normally seek to identify and implement solutions that fully address their concerns; where they are not, the prompt and orderly exit of institutions that are no longer able to meet supervisory requirements is a necessary part of an efficient financial system. Forebearance, whether or not the result of political pressure, normally leads to worsening problems and higher resolution costs. The supervisory agency should be responsible for, or assist in, the orderly exit of problem banks in order to ensure that depositors are repaid to the fullest extent possible from the resources of the bank (supplemented by any applicable deposit insurance)[3] and ahead of shareholders, subordinated debt holders and other connected parties.

[3]Text of footnote omitted.

In some cases, the best interests of depositors may be served by some form of restructuring, possibly takeover by a stronger institution or injection of new capital or shareholders. Supervisors may be able to facilitate such outcomes. It is essential that the end result fully meets all supervisory requirements, that it is realistically achievable in a short and determinate time frame, and that, in the interim, depositors are protected.

5. Deciding on the ***appropriate level of systemic protection*** is by and large a policy question to be taken by the relevant authorities (including the central bank), particularly where it may result in a commitment of public funds. Supervisors will also normally have a role to play because of their in-depth knowledge of the institutions involved. In order to preserve the operational independence of supervisors, it is important to draw a clear distinction between this systemic protection (or safety net) role and day-to-day supervision of solvent institutions. In handling systemic issues, it will be necessary to address, on the one hand, risks to confidence in the financial system and contagion to otherwise sound institutions, and, on the other hand, the need to minimise the distortion to market signals and discipline. Deposit insurance arrangements, where they exist, may also be triggered.

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LIST OF CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Preconditions for Effective Banking Supervision

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Licensing and Structure

2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The

licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organsation is a foreign bank, the prior consent of its home country supervisor should be obtained.

4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Prudential Regulations and Requirements

6. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

7. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision

16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

18. Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.

19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Information Requirements

21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of

the financial condition of the bank and profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Formal Powers of Supervisors

22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Cross-border Banking

23. Banking supervisors must practise global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures, and subsidiaries.

24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Appendix III

2 Tripartite Group of Bank, Securities, and Insurance Regulators' Report: The Supervision of Financial Conglomerates

[Excerpt][1]

Executive Summary

Introduction

1. The deregulation of domestic financial markets over the past decade together with the internationalisation of financial markets has led to new ways and means of doing business in the highly competitive, integrated world economy of the 1980s and 1990s. One notable development has been the emergence of **financial conglomerates**, often with significantly large balance sheets (and off-balance-sheet positions), providing a wide range of financial services in a variety of geographic locations.

2. Over the past several years, a number of supervisory and regulatory groups within the international financial community have sought to explore the ways in which some of their concerns relating to the supervision of financial conglomerates could be addressed. Those groups have approached the subject from the perspective of a particular sector—the supervision of banks, or of securities firms, or of insurance companies. This report brings together the efforts of a Tripartite Group of bank, securities and insurance regulators, who are acting in a personal capacity but are able to draw on the experience of their respective institutions. The Tripartite Group was set up at the beginning of 1993 specifically to consider ways of improving the supervision of financial conglomerates.

Working definition

3. The Tripartite Group agreed that, for its purposes, the term "financial conglomerate" would be used to refer to "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)". It was recognised that many of the problems encountered in the supervision of financial conglomerates would also arise in the case of "mixed conglomerates" offering not only financial services (perhaps restricted to just one of the three sectors men-

[1]This text is an excerpt from *The Supervision of Financial Conglomerates* (July 1995), a report by the Tripartite Group of Bank, Securities and Insurance Regulators.

tioned above), but also non-financial or commercial services. However, the primary focus of this report is on financial conglomerates.

Present situation

4. The present situation with regard to the supervision of conglomerates was clarified through the medium of a questionnaire (Appendix II to this report analyses the responses). This provided valuable information on the types of financial conglomerates in existence and their different structural features, many of which are largely a reflection of national laws and traditions. From the responses to the questionnaire, it was also possible to compare approaches to the overall supervision of financial conglomerates.

Identification of issues

5. Subsequently, building on previous work in other forums, the Tripartite Group identified a number of problems which financial conglomerates pose for supervisors, and discussed ways in which these problems might be overcome. Among the issues discussed were the overall approach to the supervision of financial conglomerates; the assessment of capital adequacy and ways of preventing double gearing; contagion, in particular the effect of intra-group exposures; large exposures at group level; problems in applying a suitability test to shareholders and a fitness and propriety test to managers; transparency of group structures; the exchange of prudential information between supervisors responsible for different entities within a conglomerate; rights of access to information about non-regulated entities; supervisory arbitrage; and mixed conglomerates.

Overall approach to supervision

6. The rapid growth of financial conglomerates which cut across the banking, securities and insurance sectors raises questions as to whether the traditional approach to prudential supervision—whereby each supervisor monitors institutions in one constituency without much contact with supervisors responsible for other parts of the group—is still appropriate. Fundamentally, the Tripartite Group agreed that supervision of financial conglomerates cannot be effective if the individual components of a group are supervised on a purely solo basis. The solo supervision of individual entities continues to be of primary importance, but it needs to be complemented by an assessment from a group-wide perspective.

Capital adequacy

7. Banks, insurance companies and securities firms are subject to different prudential requirements, and accordingly supervisors face a difficult problem in determining whether there is adequate capital coverage.

The Tripartite Group discussed this issue in some depth and concluded that the desired group-wide perspective can be achieved either by adopting a consolidated type of supervision, or by a "solo-plus" approach to supervision.[2] For the purposes of this report, the following working definitions were agreed upon:

- **Consolidated supervision**—This supervisory approach focuses on the parent or holding company, although individual entities may (and the Tripartite Group advocates that they should) continue to be supervised on a solo basis according to the capital requirements of their respective regulators. In order to determine whether the group as a whole has adequate capital, the assets and liabilities of individual companies are consolidated; capital requirements are applied to the consolidated entity at the parent company level; and the result is compared with the parent's (or group's) capital.

- **Solo-plus supervision**—This supervisory approach focuses on individual group entities. Individual entities are supervised on a solo basis according to the capital requirements of their respective regulators. The solo supervision of individual entities is complemented by a general qualitative assessment of the group as a whole and, usually, by a quantitative group-wide assessment of the adequacy of capital. There are several ways in which this quantitative assessment can be carried out (see below).

8. Recognising the different starting points of the solo-plus and consolidated supervision approaches, the Tripartite Group discussed a range of techniques available to supervisors for making a quantitative assessment of capital adequacy in a financial conglomerate. The Group recognised the value of accounting-based consolidation (involving a comparison, on a single set of valuation principles, of total consolidated group assets and liabilities, and the application at parent level of capital adequacy rules to the consolidated figures) as an appropriate technique for assessing capital adequacy in **homogeneous groups**. This is the technique commonly used by bank supervisors in respect of banking groups;

[2]Some members consider that a quantitative assessment of group-wide capital could be inappropriate if its usefulness in terms of improved risk assessment for a regulated entity would be less than its potential drawbacks in terms of moral hazard or real or apparent extension of a safety net to include affiliates of the regulated entity. This situation could arise, for example, if the regulated entity were very small relative to the overall group, and there were strong legal restrictions on the relationships and nature of allowable business transactions between the regulated entity and its affiliates. In such cases, a quantitative assessment of capital adequacy for the overall group would have little value in assessing the risks for the regulated entity. If such an approach were construed as bringing the affiliates within the supervisory structure applicable to the regulated entity, the overall effect could be negative.

under European legislation, it is also a technique applied to groups made up of banks and securities companies.

9. As a means of applying accounting-based consolidation in respect of **heterogenous groups**, the Tripartite Group considered a technique referred to as **"block capital adequacy"**, which envisages the classification and aggregation of assets and liabilities according to the type of risk involved (rather than according to the institution to which they pertain), and the development of harmonised standards for assessing a conglomerate's capital requirement. However, this technique was not thought to be a practical possibility for heterogenous groups in the immediately foreseeable future.

10. Instead, the Tripartite Group concluded that three techniques—the **"building-block prudential approach"** (which takes as its basis the consolidated accounts at the level of the parent company), a simple form of **risk-based aggregation** and **risk-based deduction**—are all capable of providing an accurate insight into the risks and capital coverage. It is suggested that these three techniques might form the basis of a set of minimum ground rules for the assessment of capital adequacy in financial conglomerates and that some form of mutual recognition of their acceptability would be eminently desirable. The Group also agreed that **"total deduction"** might be recognised as a fourth technique, which deals effectively and conservatively with double gearing but one which does not in itself seek to provide a full picture of the risks being carried by the conglomerate. The type and structure of the conglomerate in question may determine which of these four techniques is most appropriate for supervisory use.

11. Detailed consideration was given to the way in which supervisors should regard a parent institution's participation of less than 100% in a financial subsidiary for the purposes of assessing group capital adequacy. It was agreed that simple minority shareholdings over which the group has neither control nor significant influence (i.e. less than 20% of the shares or voting rights owned) should not be taken into account for group capital adequacy purposes. They would normally simply be regarded as portfolio investments and would be treated by the parent's supervisor in accordance with the relevant solo rules. Only in exceptional circumstances would supervisors expect to integrate such shareholdings in an assessment of capital adequacy from a group perspective.

12. Where the group has what is deemed to be a "significant influence" (i.e. ownership of between 20% and 50% of the shares or voting rights) over a subsidiary undertaking, a pro-rata approach is advocated with regard to the inclusion of capital in the group-wide assessment. As far as subsidiary undertakings which are not wholly-owned, but over

which the group has effective control (i.e. more than 50% of the shares or voting rights), are concerned, most members of the Tripartite Group agreed that the full extent of any deficit should be attributed to the group. However, there was less of a consensus as to the appropriate treatment for any capital surplus in such a subsidiary. Some members favoured attributing such surpluses in full to the parent group for capital adequacy purposes, while others considered a pro-rata approach to be more appropriate. A few members were inclined towards an asymmetric approach, under which any capital deficit would be attributed to the group in full but surpluses would only be attributed pro-rata.

13. The suitability and availability of capital surpluses for transfer from subsidiary to parent, and from one subsidiary to a sister company, were other issues considered by the Tripartite Group. The divergent definitions of capital from sector to sector, make it necessary for supervisors to examine both the distribution and structure of capital across a financial conglomerate in order to ensure that excess capital in one group entity, which is used to cover risks in another, is suitable for those purposes. The Group agreed that the simplest approach would be to assess the extent and nature of any excess in a dependant by reference to the capital requirements of that dependant; but to admit any excess for the purposes of the parent only to the extent that the excess capital elements are suitable according to the rules applied to the parent (or other regulated entity). The supervisors of the parent and the dependant would clearly need to liaise closely over the acceptability and admission of different forms of capital.

14. As far as availability is concerned, some members of the Tripartite Group, recognising various obstacles to the free movement of capital surpluses around a group, are in favour of applying a test before accepting that surpluses in individual group entities are available at parent/group level. Other members of the Group, however, view a financial conglomerate as a single economic unit and, from a "going concern" perspective, they are prepared to assume that capital surpluses in individual entities are available to the group as a whole. It did not prove possible to reach consensus on this point.

15. A difficult problem occurs when a group includes substantial non-regulated entities, either at the ownership level or downstream. The Tripartite Group is of the view that, notwithstanding moral hazard, supervisors should be able to obtain prudential information about the unregulated entities in a group in order to supervise the regulated parts effectively, and to be able to conduct a group-based risk assessment. Most members of the Group take the view that unregulated entities whose activities are similar to those of regulated entities should be included in

group-wide assessments of capital adequacy through the application of notional capital requirements derived from the analogous regulated activity.[3] A small minority of the Group, on the other hand, have a preference for the establishment of qualitative standards aimed at the regulated entities (rather than notional capital requirements for the unregulated ones) wherever they appear in the group structure. Most members also advocate that unregulated holding companies at the top of the group structure and intermediate holding companies should be encompassed in the group-wide assessment of capital adequacy.

Contagion

16. Contagion is recognised as one of the most important issues facing supervisors in relation to conglomerates. Psychological contagion—where problems in one part of a group are transferred to other parts by market reluctance to deal with a tainted group—is difficult for supervisors to guard against. However, contagion resulting from the existence of extensive intra-group exposures can, in principle, be contained and the Tripartite Group believes that, at the very minimum, it is essential for supervisors to be informed on a regular basis of the existence and nature of all such exposures.

Intra-group exposures

17. The Group takes the view that the potential problems of intra-group exposures are best tackled as an element of solo supervision, not least because the parent regulator's perspective is likely to be quite different from that of a subsidiary's regulator. Solo regulators should ensure that the pattern of activity and aggregate exposure between the regulated entity for which they are responsible and other group companies is not such that failure of another group company (or the mere existence of such intra-group transactions) will undermine the regulated entity. Solo supervisors also need to liaise closely with other group supervisors when uncertainties arise; they need powers to limit or prohibit intra-group exposures when necessary; and they should be particularly concerned about situations where funds are being invested by a subsidiary in securities issued by a parent, or are being deposited directly with a parent.

Large exposures at group level

18. Wide differences between the large exposure rules pertaining in the banking, securities and insurance sectors provide ample scope for reg-

[3]In determining these notional needs, some supervisors might also refer to the requirements established by the market for firms to obtain high credit ratings and ready access to low cost funding.

ulatory arbitrage, and the differences are such that it is difficult to envisage the gaps being bridged in the foreseeable future. The Tripartite Group agreed that a combination of large exposures to the same counterparty in different parts of a conglomerate could be dangerous to the group as a whole and a group-wide perspective is therefore considered necessary. One practical way of proceeding might be to develop a system whereby the parent or lead regulator is furnished with sufficient information to enable him to assess major group-wide exposures to individual counterparties; this would provide valuable information on gross exposures. It might be possible to identify suitable "trigger points" of concern which, when reached, would trigger discussions on a case-by-case basis between the supervisors involved on the nature of any perceived problems and on any proposed action to be taken.

Fit and proper test for managers

19. Most supervisors already have the power to check the fitness and propriety of the managers of the firms for which they are responsible. The problem facing supervisors in applying such tests is that, as the banking, insurance and securities businesses become more and more integrated, it is possible that decision-making processes will be shifted away from individually-regulated entities to the parent or holding company level of the structure, enabling managers of other (perhaps unregulated) companies in the group to exercise control over the regulated entity. Because of this, the Tripartite Group believes that, in applying the fit and proper test to managers, supervisors should be able to "look through" a conglomerate's legal structure and focus on the people who are actually managing the supervised entity, regardless of exactly where they feature in the group's organigram.

Structure

20. The Tripartite Group is of the view that the way in which a conglomerate is structured is crucial to effective supervision. It believes that supervisors need powers, at both the authorisation stage and on a continuing basis, to obtain adequate information regarding managerial and legal structures, and, if necessary, to prohibit structures which impair adequate supervision. Where supervision is impaired, supervisors should be able to insist that financial conglomerates organise themselves in a way that makes adequate supervision possible.

Suitability of shareholders

21. The Tripartite Group is of the view that shareholders who have a stake in a financial conglomerate (enabling them to exert material influence on a regulated firm within it) should meet certain standards, and

that supervisors should endeavour to ensure that this is the case by applying, on an objective basis, an appropriate test, both at the authorisation stage and on an ongoing basis. Responsibility for applying such a test clearly rests with the supervisors of individually regulated entities, but the Tripartite Group advocates close cooperation between supervisors and a sharing of information on shareholders in this respect.

Access to information

22. In the case of a financial conglomerate, intensive cooperation between supervisors is essential and supervisors should have the right to exchange prudential information. There was general support for the idea of appointing a lead supervisor or "convenor", who would be responsible for gathering such information as they require in order to have a perspective on the risks assumed by the group as a whole (including information on non-regulated entities). Using this data, a convenor would make an assessment of the capital adequacy of the group and would also be responsible for ensuring that the supervisors of individual entities are made aware of any developments which might affect the financial viability of the group. In addition, when supervisory action involving more than one regulated entity is called for, the convenor would be responsible for the coordination of this action. This would not interfere with the power of the solo supervisor to obtain information regarding the group and to act individually when necessary. In all probability, the convenor would be the supervisor of the dominant operational business entity in a group. The Tripartite Group also believes that the precise role of the lead regulator or convenor, and indeed the responsibilities of all individual supervisors involved in a financial conglomerate, could be defined and agreed upon effectively through the establishment of Memoranda of Understanding or Protocols between the relevant supervisors, particularly when a financial conglomerate has a complex structure. Where the relevant supervisors are located in the same country, however, more informal information sharing arrangements may be sufficient. External auditors are recognised as another valuable source of information for supervisors.

Mixed conglomerates

23. Although many of the problems associated with the supervision of financial conglomerates also arise in the case of "mixed conglomerates" (groups which are predominantly industrially or commercially oriented but contain at least one regulated financial entity), the latter also raise some rather different issues for supervisors and can demand a fundamentally different approach. For example, there are difficult issues to be tackled in ascertaining the suitability of the shareholders of the regulated entities and the fitness and propriety of the managers responsible for run-

ning the regulated businesses. Intra-group exposures are another problem area and it is essential that supervisors establish that such business is conducted at "arm's length" (i.e. at the terms prevailing in the market in general at the time). Clearly, there is scope for supervisory discretion in this area, but supervisors must be satisfied that, as a rule, intra-group business is not being conducted at rates or on terms which significantly differ from those prevailing generally.[4]

24. At the heart of the problem with regard to mixed conglomerates is the difficulty for supervisors in assessing overall group capital adequacy because supervisory rules and practices cannot be extended to commercial and industrial entities in the same way as they can to non-regulated financial entities. The Tripartite Group believes that, ideally, supervisors should be able to insist on the establishment of an intermediate holding company to provide a legal separation of the regulated financial parts of a mixed conglomerate from the non-financial parts; this would enable supervision to be carried out in the same way as for other financial conglomerates.

Conclusion

25. In summary, considerable progress has been made in identifying broad areas of agreement between supervisors in the three disciplines and a number of recommendations have been made as to ways in which the supervision of financial conglomerates could be improved. However, any further progress that can be made by the Tripartite Group seems certain to be restricted by the informal nature of the group. It is hoped that this paper will provide a sound basis for any further work that may be undertaken in this regard.

[4]It is recognised that, in certain circumstances, it might be perfectly reasonable to expect a parent to provide support at off-market conditions to its subsidiaries. Supervisory authorities might actually require such support on occasions.

Appendix III

3 Joint Report on the Supervision of Cross-Border Banking

[Excerpt][1]

II. Summary of conclusions and recommendations

1. Improving the access of home supervisors to information necessary for effective consolidated supervision

(i) In order to exercise comprehensive consolidated supervision of the global activities of their banking organisations, home supervisors must be able to make an assessment of all significant aspects of their banks' operations that bear on safety and soundness, wherever those operations are conducted and using whatever evaluative techniques are central to their supervisory process.[2]

(ii) Home supervisors need to be able to verify that quantitative information received from banking organisations in respect of subsidiaries and branches in other jurisdictions is accurate and to reassure themselves that there are no supervisory gaps.

(iii) While recognising that there are legitimate reasons for protecting customer privacy, the working group believes that secrecy laws should not impede the ability of supervisors to ensure safety and soundness in the international banking system.

(iv) If the home supervisor needs information about non-deposit operations, host supervisors are encouraged to assist in providing the requisite information to home supervisors if this is not provided through other supervisory means. The working group believes it is essential that national legislation that in any way obstructs the passage of non-deposit supervisory information be amended.

(v) Where the liabilities side of the balance sheet is concerned, home supervisors do not routinely need to know the identity of individual

[1]This text is an excerpt from *The Supervision of Cross-Border Banking* (October 1996), a report by a working group composed of members of the Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors.

[2]Cross references to paragraphs of the report are omitted.

depositors. However, in certain well-defined circumstances, home supervisors would need access to individual depositors' names and to deposit account information.

(vi) It should not normally be necessary for the home supervisor to know the identity of investors for whom a bank in a host country is managing investments at the customer's risk. However, in certain exceptional circumstances, home supervisors would need access to individual investors' names and to investment account information subject to the safeguards in paragraph 10.

(vii) The working group recommends that host supervisors whose legislation does not allow a home supervisor to have access to depositor information use their best endeavours to have their legislation reviewed and if necessary amended to provide for a mechanism whereby in exceptional cases a home supervisor, with the consent of the host supervisor, will gain access to depositor information subject to the same conditions as outlined in (viii) below.

(viii) In order to provide legitimate protection for bank customers, it is important that the information obtained by home supervisors, especially that relating to depositors' or investors' names, is subject to strict confidentiality. The working group recommends that those host jurisdictions whose legislation allows foreign supervisors to have access to banks' depositor or investor information should subject such access (at the host country's discretion) to the following conditions:

- the purpose for which the information is sought should be specific and supervisory in nature;
- information received should be restricted solely to officials engaged in prudential supervision and not be passed to third parties without the host supervisor's prior consent;[3]
- there is assurance that all possible steps will be taken to preserve the confidentiality of information received by a home supervisor in the absence of the explicit consent of the customer;
- there should be a two-way flow of information between the host and home supervisors, though perfect reciprocity should not be demanded;
- before taking consequential action, those receiving information will undertake to consult with those supplying it.

[3]Text of footnote omitted.

(ix) If a host supervisor has good cause to doubt a home supervisor's ability to limit the use of information obtained in confidence solely for supervisory purposes, the host would retain the right not to provide such information.

(x) Subject to appropriate protection for the identity of customers, home supervisors should be able at their discretion, and following consultation with the host supervisor, to carry out on-site inspections in other jurisdictions for the purposes of carrying out effective comprehensive consolidated supervision. This ability should include, with the consent of the host supervisor and within the laws of the host country, the right to look at individual depositors' names and relevant deposit account information if the home supervisor suspects serious crime. . . . If a host supervisor has reason to believe that the visit is for non-supervisory purposes, it should have the right to prevent the visit taking place or to terminate the inspection.

(xi) It would avoid potential misunderstandings if a standard routing were laid down for conducting cross-border inspections along the lines recommended in Annex A.

(xii) In those countries where laws do not allow for on-site inspections by supervisors from other jurisdictions, the working group advocates that host supervisors use their best endeavours to have their legislation amended. In the meantime, host supervisors should, within the limits of their laws, be willing to cooperate with any home supervisor that wishes to make an inspection. The working group believes that the host supervisor should have the option to accompany the home supervisor throughout the inspection.

(xiii) It is important that the confidentiality of information obtained during the course of an inspection be maintained. Home supervisors should use their best endeavours to have their legislation modified if it does not offer sufficient protection that information obtained for the purposes of effective consolidated supervision is limited to that use.

(xiv) In the event that a home supervisor, during an on-site inspection in a host country, detects a serious criminal violation of home country law, the home supervisor may be under a strict legal obligation to pass the information immediately to the appropriate law enforcement authorites in its home country. In these circumstances, the home supervisor

should inform the host supervisor of the action he intends to take.[4]

(xv) In order to carry out effective comprehensive consolidated supervision, home supervisors also need information on certain *qualitative* aspects of the business undertaken in other jurisdictions by branches and subsidiaries of banking organisations for which they are the home supervisor. All members of the working group agree that it is essential for effective consolidated supervision that there are no impediments to the passing of such qualitative information to the home supervisor.

2. Improving the access of host supervisors to information necessary for effective host supervision

(xvi) In the case of information which is *specific to the local entity,* an early sharing of information may be important in enabling a potential problem to be resolved before it becomes serious. The home supervisor should therefore consult the host supervisor in such cases and the latter should report back on its findings. In particular, it is essential that the home supervisor inform the host supervisor immediately if the former has reason to suspect the integrity of the local operation, the quality of its management or the quality of internal controls being exercised by the parent bank.

(xvii) A home supervisor should have on its regular mailing list for relevant material all foreign supervisors which act as hosts to its banks.

(xviii) While the working group agrees that home supervisors should endeavour to keep host supervisors appraised of material adverse changes in the global condition of banking groups, the Group recognises that this will typically be a highly sensitive issue and that decisions on information-sharing necessarily will have to be made on a case-by-case basis.

3. Ensuring that all cross-border banking operations are subject to effective home and host supervision

(xix) The working group has formulated a set of principles of effective consolidated supervision (see Annex B) which could be

[4]Some members of the working group strongly believe, as is required by their laws, that the home supervisor should be expected to obtain approval from the host country supervisor before informing the home country law enforcement authorities of any suspected violations of home country law.

used by host supervisors as a checklist to assist in determining whether a home supervisor is meeting the Minimum Standards.

(xx) Regional group procedures might be used to support the implementation of the Minimum Standards, as the Offshore Group is now doing.

(xxi) The working group recommends that other regional groups consider the possibility of using a checklist similar to the one used by the Offshore Group (see Annex C) as a means of establishing which of their members might be certified as meeting certain general criteria.

(xxii) The Basle Committee encourages its member countries to assist the Offshore Group or another regional group in the fact-finding verification process, but any decision-making regarding membership of a regional group should be left to that group alone. The Committee has asked its Secretariat to maintain a list of competent persons (for example, retired supervisors) who are available to undertake exercises of this nature.

(xxiii) The supervisor that licenses a so-called shell branch has responsibility for ensuring that there is effective supervision of that shell branch. No banking operation should be permitted without a license, and no shell office should be licensed without ascertaining that it will be subject to effective supervision. In the event that any host supervisor receives an application to license a new shell branch that will be managed in another jurisdiction, that supervisor should take steps to notify both the home supervisor and the appropriate host supervisor in the other jurisdiction in order to establish that there will be appropriate supervision of the branch before approving the application.

(xxiv) Home supervisors should not authorise their banks to establish or acquire offices in any host jurisdiction without satisfying themselves in advance that such offices will be subject to appropriate supervision.

(xxv) Where the home authority wishes to inspect on-site, they should be permitted to examine the books of the shell branch wherever they are kept. The working group believes that in no case should access to these books be protected by secrecy requirements in the country that licenses the shell branch.

(xxvi) The working group recommends that home or host supervisors be vigilant to ensure that parallel-owned banks (where a bank in one jurisdiction has the same ownership as a bank in another jurisdiction, where one is not a subsidiary of the other) become subject to consolidated supervision, if necessary by enforcing a change in group structure as indicated by the Minimum Standards.

(xxvii) Any home supervisor that licenses a banking entity has a responsibility to monitor its operations on a worldwide basis.

(xxviii) No entity should be allowed to use the word "bank" in its name if it is not conducting banking activities and being supervised as a bank.

(xxix) The working group believes the Basle Committee should advise all host countries to be extremely cautious about approving the establishment of cross-border operations by banks incorporated in under-regulated financial centres, and even more cautious about accepting other financial institutions conducting banking activities from those centres.

Annex A

Standard procedures for cross-border inspections

The working group recommends that the following routine should be followed in cases where the home supervisor wishes to undertake a cross-border inspection:

(i) The home supervisor should contact the host supervisor to let the latter know of an intention to make a visit to a specified branch/subsidiary within the host supervisor's jurisdiction;

(ii) The home supervisor should be prepared to explain to the host supervisor the purpose of the visit and what aspects of the branch or subsidiary it would wish to explore;

(iii) The host supervisor should be able to obtain an undertaking from the home supervisor that information obtained in the course of the visit will be used for specific and supervisory purposes and, to the maximum extent possible under applicable laws, will not be passed to third parties without the host supervisors' prior consent. . . . ;

(iv) The host supervisor should identify to the home supervisor any areas where access to information is normally restricted (e.g. information on individual customers), and the home supervisor should indicate where exceptions are needed;

(v) The host supervisor should have the option, but not the duty, to accompany the home supervisor during the inspections;

(vi) Where relevant, the host supervisor should advise the home supervisor of procedures necessary to comply with local/host country legislation and, where necessary or appropriate, assist in ensuring that these procedures are correctly followed to expedite the examination.

Annex B

Effective consolidated supervision

1. Under the first of the four Minimum Standards, it is required that all international banks be supervised by a home country authority that capably performs consolidated supervision. The purpose of this Annex, and in particular the checklist in paragraphs 6 and 7 below, is to provide examples of some of the principles and factors that could be taken into account in making a judgement about effective consolidated supervision.

2. There can be no single set of criteria to determine whether or not a home supervisor is performing "effective consolidated supervision", since supervisory techniques differ from country to country, due to institutional, historical, legal or other factors. The concepts of consolidated supervision can, however, be defined, namely as a group-wide approach to supervision whereby all the risks run by a banking group are taken into account, wherever they are booked. In other words, it is a process whereby a supervisor can satisfy himself about the totality of a banking group's activities, which may include non-bank companies and financial affiliates, as well as direct branches and subsidiaries.

3. One of the prime reasons why consolidated supervision is critical is the risk of a damaging loss of confidence if an associated enterprise gets into difficulties. This so-called risk of contagion goes well beyond legal liability. Consolidated supervision helps protect the integrity of, and confidence in the group, both supervised and unsupervised elements. More directly, the purpose of consolidated supervision is essentially threefold:

- to support the principle that no banking operation, wherever located, should escape supervision altogether;
- to prevent double-leveraging of capital; and
- to ensure that all the risks incurred by a banking group, no matter where they are booked, are evaluated and controlled on a global basis.

4. It is important to draw a distinction between accounting consolidation, which is a mechanical process, and the concept of consolidated

supervision, which is qualitative as well as quantitative. The drawing up of consolidated accounts facilitates consolidated supervision but is not necessarily sufficient. Consolidated accounting may, for example, be inappropriate when the nature of the business or the nature of the risks are markedly different, but that does not mean that the risks should be ignored. Moreover, some risks need to be monitored at local levels too. Liquidity concerns, for one, can be considered on a market-by-market (or currency-by-currency) basis, though a group liquidity spectrum would need to include at least the main funding centres. Market risk is another risk that the supervisor may decide should not necessarily be consolidated: that decision would depend on whether the bank manages its market risks centrally or regionally. Moreover, if a bank is operating in jurisdictions subject to controls on capital flows, offsetting of market (and other) risks through consolidation would not necessarily be prudent.

5. In reaching a decision as to the effectiveness of the consolidated supervision conducted by a home supervisor, the host supervisor will also need to take account of his own supervisory capabilities. If he has limited resources, greater demands will be placed on the home supervisor than if host supervision is strong. The host also has to judge the extent to which its supervision complements that of the home supervisor, or whether there are potential gaps. Accordingly, one host supervisor may decide that a given country is conducting effective consolidated supervision, whereas another host supervisor with different capabilities may decide that it is not. Nonetheless, there are certain common factors on which host supervisors will base their decisions. The checklist below is designed to assist in that decision-making process.

Checklist of principles for effective consolidated supervision

A. Powers to exercise global oversight

6. Does the home country supervisor have adequate powers to enable it to obtain the information needed to exercise consolidated supervision, for example:

- does the bank in question have its own routine for collecting and validating financial information from all its foreign affiliates, as well as for evaluating and controlling its risks on a global basis?
- does the home supervisor receive regular financial information relating both to the whole of the group, and to the material entities in the group (including the head office) individually?
- is the home supervisor able to verify that information (e.g. through inspection, auditors' reports or information received from the host authority)?

- is there access to information on intra-group transactions, not only with downward affiliates but also if appropriate with sister companies or non-bank affiliates?
- does the home supervisor have the power to prohibit corporate structures that deliberately impede consolidated supervision?

B. Exercise of consolidated supervision

7. Which of the following procedures does the home country supervisor have in place to demonstrate its ability to capably perform consolidated supervision:

- adequate control of authorisation, both at the entry stage and on changes of ownership?
- adequate prudential standards for capital, credit concentrations, asset quality (i.e. provisioning or classification requirements), liquidity, market risk, management controls, etc?
- off-site capability, i.e. systems for statistical reporting of risks on a consolidated basis and the ability to verify or to have the reports verified?
- the capability to inspect or examine entities in foreign locations?
- arrangements for a frequent dialogue with the management of the supervised entity?
- a track record of taking effective remedial action when problems arise?

Annex C

Offshore group of banking supervisors on-site examination checklist

1. What number, types of banks etc. are licensed in the jurisdiction? Is there any differentiation in the type of banking licence issued, or the conditions imposed and, if so, why? What legislation is in place, when was it last updated, and does it provide for the Basle Committee's minimum standards to be met?

2. What resources are available to the supervisory authority, with regard to the background and experience of the supervisory team, and what training programme is in place?

3. What are the requirements which banks/banking groups have to fulfil in order to become authorised in the jurisdiction? What measures

are in place to ensure that banks/banking groups are managed and controlled by fit and proper persons?

4. What is the process of authorisation - what objective criteria and what type of background checks are used? What arrangements are in place to ensure the approval of the home supervisor? What regular links are there with other supervisory authorities?

5. What steps are taken to ensure that banks/banking groups are subject to effective consolidated supervision?

6. What financial and prudential information is collected from banks/banking groups in the jurisdiction, and how frequently is the information collected? By what means is the reliability of this information confirmed?

7. Are on-site inspections of banks/banking groups undertaken? If not, what are the alternative arrangements? If so, who carries them out, what is their scope and what is their frequency? Is the home supervisory authority informed of examination findings?

8. What measures are taken to supervise the overseas operations of any banks/banking groups for which the Supervisory Authority is the home supervisor? Are financial conglomerates allowed? If so, what are the arrangements for supervising the operations of non-bank subsidiaries?

9. What limits are applied with regard to the extent to which a bank or banking group can lend to:

(a) any one customer (including any arrangements for treating groups of borrowers as one risk);

(b) companies or persons connected with the bank/banking group itself; and

(c) particular sectors (e.g. real estate)?

10. What rules are in place to monitor:

(a) solvency;

(b) asset quality;

(c) country risk exposure;

(d) liquidity control systems;

(e) foreign exchange positions;

(f) off-balance-sheet activity;

(g) ownership and organisation structure;

(h) derivatives activities?

What is the frequency of report on each of the above?

11. What arrangements are in place to ensure that banks/banking groups maintain adequate accounting and other records, and adequate systems of control?

12. What measures and actions can be taken if the banks/banking groups in the jurisdiction fail to comply with prudential requirements or any other factors that are a cause for concern?

13. Are internal auditors from the parent bank or head office entitled to inspect the banks in the jurisdiction? Are internal auditors required to meet with/report to the host/home supervisor?

14. Are the home supervisory authorities of banks/banking groups entitled to conduct on-site inspections?

15. What powers does the supervisory authority have to provide or share information with other supervisory authorities? What kind of information may be provided or shared? What restrictions or constraints are there (if any) on the provision or sharing of information with other supervisory authorities? What statutory or other protection is available for information passed to the supervisory authorities by other authorities?

16. Have the Basle Commmittee's capital convergence proposals been adopted?

17. What legislation, rules, etc. are in place to control money-laundering activities and to provide for the implementation of the FATF's forty recommendations?

18. Are locally incorporated subsidiaries required to publish annual audited accounts? Are all banks subject to external audit and, if so, in what form? What is the criteria for appointing/approving external auditors and do they have to be the same as the auditors of the parent/group?

Appendix IV
European Community Documents

Appendix IV

1 EC Directive on Cross-Border Credit Transfers

Council Directive[1] 27 January 1997 on cross-border credit transfers (97/5/EC)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 100a thereof,

Having regard to the proposal from the Commission,[2]

Having regard to the opinion of the Economic and Social Committee,[3]

Having regard to the opinion of the European Monetary Institute,

Acting in accordance with the procedure laid down in Article 189b of the Treaty[4] in the light of the joint text approved on 22 November 1996 by the Conciliation Committee,

(1) Whereas the volume of cross-border payments is growing steadily as completion of the internal market and progress towards full economic and monetary union lead to greater trade and movement of people within the Community; whereas cross-border credit transfers account for a substantial part of the volume and value of cross-border payments;

(2) Whereas it is essential for individuals and businesses, especially small and medium-sized enterprises, to be able to make credit transfers rapidly, reliably and cheaply from one part of the Community to another; whereas, in conformity with the Commission Notice on the application of the EC competition rules to cross-border credit transfers,[5] greater

[1]OJ No. L 43, 14.2.1997, p. 25.

[2]OJ No. C 360, 17.12.1994, p. 13, and OJ No. C 199, 3.8.1995, p. 16.

[3]OJ No. C 236, 11.9.1995, p. 1.

[4]Opinion of the European Parliament of 19 May 1995 (OJ No. C 151, 19.6.1995, p. 370), Council common position of 4 December 1995 (OJ No. C 353, 30.12.1995, p. 52) and Decision of the European Parliament of 13 March 1996 (OJ No. C 96, 1.4.1996, p. 74). Decision of the Council of 19 December 1996 and Decision of the European Parliament of 16 January 1997.

[5]OJ No. C 251, 27.9.1995, p. 3.

competition in the market for cross-border credit transfers should lead to improved services and reduced prices;

(3) Whereas this Directive seeks to follow up the progress made towards completion of the internal market, in particular towards liberalization of capital movements, with a view to the implementation of economic and monetary union; whereas its provisions must apply to credit transfers in the currencies of the Member States and in ECUs;

(4) Whereas the European Parliament, in its resolution of 12 February 1993,[6] called for a Council Directive to lay down rules in the area of transparency and performance of cross-border payments;

(5) Whereas the issues covered by this Directive must be dealt with separately from the systemic issues which remain under consideration within the Commission; whereas it may become necessary to make a further proposal to cover these systemic issues, particularly the problem of settlement finality;

(6) Whereas the purpose of this Directive is to improve cross-border credit transfer services and thus assist the European Monetary Institute (EMI) in its task of promoting the efficiency of cross-border payments with a view to the preparation of the third stage of economic and monetary union;

(7) Whereas, in line with the objectives set out in the second recital, this Directive should apply to any credit transfer of an amount of less than ECU 50,000;

(8) Whereas, having regard to the third paragraph of Article 3b of the Treaty, and with a view to ensuring transparency, this Directive lays down the minimum requirements needed to ensure an adequate level of customer information both before and after the execution of a cross-border credit transfer; whereas these requirements include indication of the complaints and redress procedures offered to customers, together with the arrangements for access thereto; whereas this Directive lays down minimum execution requirements, in particular in terms of performance, which institutions offering cross-border credit transfer services should adhere to, including the obligation to execute a cross-border credit transfer in accordance with the customer's instructions; whereas this Directive fulfils the conditions deriving from the principles set out in Commission Recommendation 90/109/EEC of 14 February 1990 on the transparency of banking conditions relating to cross-border financial transactions;[7]

[6]OJ No. C 72, 15.3.1993, p. 158.
[7]OJ No. L 67, 15.3.1990, p. 39.

whereas this Directive is without prejudice to Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering;[8]

(9) Whereas this Directive should contribute to reducing the maximum time taken to execute a cross-border credit transfer and encourage those institutions which already take a very short time to do so to maintain that practice;

(10) Whereas the Commission, in the report it will submit to the European Parliament and the Council within two years of implementation of this Directive, should particularly examine the time-limit to be applied in the absence of a time limit agreed between the originator and his institution, taking into account both technical developments and the situation existing in each Member State;

(11) Whereas there should be an obligation upon institutions to refund in the event of a failure to successfully complete a credit transfer; whereas the obligation to refund imposes a contingent liability on institutions which might, in the absence of any limit, have a prejudicial effect on solvency requirements; whereas that obligation to refund should therefore be applicable up to ECU 12,500;

(12) Whereas Article 8 does not affect the general provisions of national law whereby an institution has responsibility towards the originator when a cross-border credit transfer has not been completed because of an error committed by that institution;

(13) Whereas it is necessary to distinguish, among the circumstances with which institutions involved in the execution of a cross-border credit transfer may be confronted, including circumstances relating to insolvency, those caused by *force majeure*; whereas for that purpose the definition of *force majeure* given in Article 4 (6) of Directive 90/314/EEC of 13 June 1990 on package travel, package holidays and package tours[9] should be taken as a basis;

(14) Whereas there need to be adequate and effective complaints and redress procedures in the Member States for the settlement of possible disputes between customers and institutions, using existing procedures where appropriate,

[8]OJ No. L 166, 28.6.1991, p. 77.
[9]OJ No. L 158, 23.6.1990, p. 59.

HAVE ADOPTED THIS DIRECTIVE:

SECTION I

SCOPE AND DEFINITIONS

Article 1
Scope

The provisions of this Directive shall apply to cross-border credit transfers in the currencies of the Member States and the ECU up to the equivalent of ECU 50 000 ordered by persons other than those referred to in Article 2 (a), (b) and (c) and executed by credit institutions or other institutions.

Article 2
Definitions

For the purposes of this Directive:

(a) 'credit institution' means an institution as defined in Article 1 of Council Directive 77/780/EEC,[10] and includes branches, within the meaning of the third indent of that Article and located in the Community, of credit institutions which have their head offices outside the Community and which by way of business execute cross-border credit transfers;

(b) 'other institution' means any natural or legal person, other than a credit institution, that by way of business executes cross-border credit transfers;

(c) 'financial institution' means an institution as defined in Article 4 (1) of Council Regulation (EC) No 3604/93 of 13 December 1993 specifying definitions for the application of the prohibition of privileged access referred to in Article 104a of the Treaty;[11]

(d) 'institution' means a credit institution or other institution; for the purposes of Articles 6, 7 and 8, branches of one credit institution situated in different Member States which participate in the execution of a cross-border credit transfer shall be regarded as separate institutions;

(e) 'intermediary institution' means an institution which is neither that of the originator nor that of the beneficiary and which participates in the execution of a cross-border transfer;

[10]OJ No. L 322, 17.12.1977, p. 30. Directive as last amended by Directive 95/26/EC (OJ No. L 168, 18.7.1995, p. 7).
[11]OJ No. L 332, 31.12.1993, p. 4.

(f) 'cross-border credit transfer' means a transaction carried out on the initiative of an originator via an institution of its branch in one Member State, with a view to making available an amount of money to a beneficiary at an institution or its branch in another Member State; the originator and the beneficiary may be one and the same person;

(g) 'cross-border credit transfer order' means an unconditional instruction in any form, given directly by an originator to an institution to execute a cross-border credit transfer;

(h) 'originator' means a natural or legal person that orders the making of a cross-border credit transfer to a beneficiary;

(i) 'beneficiary' means the final recipient of a cross-border credit transfer for whom the corresponding funds are made available in an account to which he has access;

(j) 'customer' means the originator or the beneficiary, as the context may require;

(k) 'reference interest rate' means an interest rate representing compensation and established in accordance with the rules laid down by the Member State in which the establishment which must pay the compensation to the customer is situated;

(l) 'date of acceptance' means the date of fulfilment of all the conditions required by the institution as to the execution of the cross-border credit transfer order and relating to the availability of adequate financial cover and the information required to execute that order.

SECTION II

TRANSPARENCY OF CONDITIONS FOR CROSS-BORDER CREDIT TRANSFERS

Article 3

Prior information on conditions for cross-border credit transfers

The institutions shall make available to their actual and prospective customers in writing, including where appropriate by electronic means, and in a readily comprehensible form, information on conditions for cross-border credit transfers. This information shall include at least:

— indication of the time needed, when a cross-border credit transfer order given to the institution is executed, for the funds to be credited to the account of the beneficiary's institution; the start of that period must be clearly indicated,

— indication of the time needed, upon receipt of a cross-border credit transfer, for the funds credited to the account of the institution to be credited to the beneficiary's account,

— the manner of calculation of any commission fees and charges payable by the customer to the institution, including where appropriate the rates,

— the value date, if any, applied by the institution,

— details of the complaint and redress procedures available to the customer and arrangements for access to them,

— indication of the reference exchange rates used.

Article 4

Information subsequent to a cross-border credit transfer

The institutions shall supply their customers, unless the latter expressly forgo this, subsequent to the execution or receipt of a cross-border credit transfer, with clear information in writing, including where appropriate by electronic means, and in a readily comprehensible form. This information shall include at least:

— a reference enabling the customer to identify the cross-border credit transfer,

— the original amount of the cross-border credit transfer,

— the amount of all charges and commission fees payable by the customer,

— the value date, if any, applied by the institution.

Where the originator has specified that the charges for the cross-border credit transfer are to be wholly or partly borne by the beneficiary, the latter shall be informed thereof by his own institution.

Where any amount has been converted, the institution which converted it shall inform its customer of the exchange rate used.

SECTION III

MINIMUM OBLIGATIONS OF INSTITUTIONS IN RESPECT OF CROSS-BORDER CREDIT TRANSFERS

Article 5

Specific undertakings by the institution

Unless it does not wish to do business with that customer, an institution must at a customer's request, for a cross-border credit transfer with

stated specifications, give an undertaking concerning the time needed for execution of the transfer and the commission fees and charges payable, apart from those relating to the exchange rate used.

Article 6

Obligations regarding time taken

1. The originator's institution shall execute the cross-border credit transfer in question within the time limit agreed with the originator.

Where the agreed time limit is not complied with or, in the absence of any such time limit, where, at the end of the fifth banking business day following the date of acceptance of the cross-border credit transfer order, the funds have not been credited to the account of the beneficiary's institution, the originator's institution shall compensate the originator.

Compensation shall comprise the payment of interest calculated by applying the reference rate of interest to the amount of the cross-border credit transfer for the period from:

— the end of the agreed time limit or in the absence of any such time limit, the end of the fifth banking business day following the date of acceptance of the cross-border credit transfer order, to

— the date on which the funds are credited to the account of the beneficiary's institution.

Similarly, where non-execution of the cross-border credit transfer within the time limit agreed or, in the absence of any such time limit, before the end of the fifth banking business day following the date of acceptance of the cross-border credit transfer is attributable to an intermediary institution, that institution shall be required to compensate the originator's institution.

2. The beneficiary's institution shall make the funds resulting from the cross-border credit transfer available to the beneficiary within the time limit agreed with the beneficiary.

Where the agreed time limit is not complied with or, in the absence of any such time limit, where, at the end of the banking business day following the day on which the funds were credited to the account of the beneficiary's institution, the funds have not been credited to the beneficiary's account, the beneficiary's institution shall compensate the beneficiary.

Compensation shall comprise the payment of interest calculated by applying the reference rate of interest to the amount of the cross-border credit transfer for the period from:

— the end of the agreed time limit or, in the absence of any such time limit, the end of the banking business day following the day on which the funds were credited to the account of the beneficiary's institution, to

— the date on which the funds are credited to the beneficiary's account.

3. No compensation shall be payable pursuant to paragraphs 1 and 2 where the originator's institution or, as the case may be, the beneficiary's institution can establish that the delay is attributable to the originator or, as the case may be, the beneficiary.

4. Paragraphs 1, 2 and 3 shall be entirely without prejudice to the other rights of customers and institutions that have participated in the execution of a cross-border credit transfer order.

Article 7

Obligation to execute the cross-border transfer in accordance with instructions

1. The originator's institution, any intermediary institution and the beneficiary's institution, after the date of acceptance of the cross-border credit transfer order, shall each be obliged to execute that credit transfer for the full amount thereof unless the originator has specified that the costs of the cross-border credit transfer are to be borne wholly or partly by the beneficiary.

The first subparagraph shall be without prejudice to the possibility of the beneficiary's institution levying a charge on the beneficiary relating to the administration of his account, in accordance with the relevant rules and customs. However, such a charge may not be used by the institution to avoid the obligations imposed by the said subparagraph.

2. Without prejudice to any other claim which may be made, where the originator's institution or an intermediary institution has made a deduction from the amount of the cross-border credit transfer in breach of paragraph 1, the originator's institution shall, at the originator's request, credit, free of all deductions and at its own cost, the amount deducted to the beneficiary unless the originator requests that the amount be credited to him.

Any intermediary institution which has made a deduction in breach of paragraph 1 shall credit the amount deducted, free of all deductions and at its own cost, to the originator's institution or, if the originator's institution so requests, to the beneficiary of the cross-border credit transfer.

3. Where a breach of the duty to execute the cross-border credit transfer order in accordance with the originator's instructions has been caused

by the beneficiary's institution, and without prejudice to any other claim which may be made, the beneficiary's institution shall be liable to credit the beneficiary, at its own cost, any sum wrongly deducted.

Article 8

Obligation upon institutions to refund in the event of non-execution of transfers

1. If, after a cross-border credit transfer order has been accepted by the originator's institution, the relevant amounts are not credited to the account of the beneficiary's institution, and without prejudice to any other claim which may be made, the originator's institution shall credit the originator, up to ECU 12 500, with the amount of the cross-border credit transfer plus:

— interest calculated by applying the reference interest rate to the amount of the cross-border credit transfer for the period between the date of the cross-border credit transfer order and the date of the credit, and

— the charges relating to the cross-border credit transfer paid by the originator.

These amounts shall be made available to the originator within fourteen banking business days following the date of his request, unless the funds corresponding to the cross-border credit transfer have in the meantime been credited to the account of the beneficiary's institution.

Such a request may not be made before expiry of the time limit agreed between the originators' institution and the originator for the execution of the cross-border credit transfer order or, in the absence of any such time limit, before expiry of the time limit laid down in the second subparagraph of Article 6 (1).

Similarly, each intermediary institution which has accepted the cross-border credit transfer order owes an obligation to refund at its own cost the amount of the credit transfer, including the related costs and interest, to the institution which instructed it to carry out the order. If the cross-border credit transfer was not completed because of errors or omissions in the instructions given by that institution, the intermediary institution shall endeavour as far as possible to refund the amount of the transfer.

2. By way of derogation from paragraph 1, if the cross-border credit transfer was not completed because of its non-execution by an intermediary institution chosen by the beneficiary's institution, the latter institution shall be obliged to make the funds available to the beneficiary up to ECU 12 500.

3. By way of derogation from paragraph 1, if the cross-border credit transfer was not completed because of an error or omission in the instruc-

tions given by the originator to his institution or because of non-execution of the cross-border credit transfer by an intermediary institution expressly chosen by the originator, the originator's institution and the other institutions involved shall endeavour as fast as possible to refund the amount of the transfer.

Where the amount has been recovered by the originator's institution, it shall be obliged to credit it to the originator. The institutions, including the originator's institution, are not obliged in this case to refund the charges and interest accruing, and can deduct the costs arising from the recovery if specified.

Article 9

Situation of *force majeure*

Without prejudice to the provisions of Directive 91/308/EEC, institutions participating in the execution of a cross-border credit transfer order shall be released from the obligations laid down in this Directive where they can adduce reasons of *force majeure,* namely abnormal and unforeseeable circumstances beyond the control of the person pleading *force majeure,* the consequences of which would have been unavoidable despite all efforts to the contrary, which are relevant to its provisions.

Article 10

Settlement of disputes

Member States shall ensure that there are adequate and effective complaints and redress procedures for the settlement of disputes between an originator and his institution or between a beneficiary and his institution, using existing procedures where appropriate.

SECTION IV

FINAL PROVISIONS

Article 11

Implementation

1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 14 August 1999 at the latest. They shall forthwith inform the Commission thereof.

When Member States adopt these provisions, they shall contain a reference to this Directive or shall be accompanied by such reference on the occasion of their official publication. The methods of making such reference shall be laid down by Member States.

2. Member States shall communicate to the Commission the text of the main laws, regulations or administrative provisions which they adopt in the field governed by this Directive.

Article 12

Report to the European Parliament and the Council

No later than two years after the date of implementation of this Directive, the Commission shall submit a report to the European Parliament and the Council on the application of this Directive, accompanied where appropriate by proposals for its revision.

This report shall, in the light of the situation existing in each Member State and of the technical developments that have taken place, deal particularly with the question of the time limit set in Article 6 (1).

Article 13

Entry into force

This Directive shall enter into force on the date of its publication in the *Official Journal of the European Communities.*

Article 14

Addressees

This Directive is addressed to the Member States.

Done at Brussels, 27 January 1997.

For the European Parliament
The President
J.M. GIL-ROBLES

For the Council
The President
G. ZALM

Appendix IV

2 EC Directive as Regards Recognition of Contractual Netting by the Competent Authorities

Council Directive[1] 21 March 1996 amending Directive 89/647/EEC as regards recognition of contractual netting by the competent authorities (96/10/EC)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 57 (2) thereof,

Having regard to the proposal from the Commission,[2]

Having regard to the opinion of the Economic and Social Committee,[3]

Having regard to the opinion of the European Monetary Institute,[4]

Acting in accordance with the procedure laid down in Article 189b of the Treaty,[5]

Whereas Annex II to Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions[6] lays down the treatment of off-balance-sheet items concerning interest and foreign-exchange rates in the context of the calculation of credit institutions' capital requirements;

Whereas with a view to the smooth functioning of the internal market and in particular with a view to ensuring a level playing field Member

[1]OJ No. L 85 3.4.1996, p. 17.

[2]OJ No. C 142, 25.5.1994, p. 8, and OJ No. C 165, 1.7.1995, p. 6.

[3]OJ No. C 393, 31.12.1994, p. 30.

[4]Opinion delivered on 16 January 1995 (not yet published in the Official Journal).

[5]Opinion of the European Parliament of 16 February 1995 (OJ No. C 56, 6.3.1995, p. 79), Council common position of 5 September 1995 (OJ No. C 288, 30.10.1995, p. 30) and Decision of the European Parliament of 14 December 1995 (OJ No. C 17, 22.1.1996). Council Decision of 26 February 1996.

[6]OJ No. L 386, 30.12.1989, p. 14. Directive as last amended by Commission Directive 95/15/EC (OJ No. L 125, 8.6.1995, p. 23).

States are obliged to strive for uniform assessment of contractual netting agreements by their competent authorities;

Whereas this Directive is in accordance with the work of an international forum of banking supervisors on the supervisory recognition of bilateral netting, in particular the possibility of calculating the own-funds requirements for certain transactions on the basis of a net rather than a gross amount provided that there are legally binding agreements which ensure that the credit risk is confined to the net amount;

Whereas the rules contemplated for the supervisory recognition of netting at the wider international level will lead to the possibility of reducing the capital requirements for internationally active credit institutions and groups of credit institutions in a wide range of non-member countries credit institutions which compete with Community credit institutions;

Whereas for credit institutions incorporated in the Member States, only an amendment of Directive 89/647/EEC can create a similar possibility for the recognition of bilateral netting by the competent authorities and thereby offer them equal conditions of competition; whereas the rules are both well balanced and appropriate for the further reinforcement of the application of prudential supervisory measures to credit institutions;

Whereas the competent authorities in the Member States should ensure that the calculation of add-ons is based on effective rather than apparent notional amounts;

Whereas, having regard to this situation, this Directive complies with the principle of subsidiarity, since the aim of this Directive can be achieved only by means of the harmonized amendment of existing Community legislation,

HAVE ADOPTED THIS DIRECTIVE:

Article 1

Annex II to Directive 89/647/EEC shall be replaced by the Annex hereto.

Article 2

Article 1 shall be without prejudice to the competent authorities' recognition of bilateral contracts for novation concluded before the entry into force of the laws, regulations and administrative provisions necessary for the implementation of this Directive.

Article 3

1. Member States shall bring into force the laws, regulations and administrative provisions necessary for them to comply with this Directive after its entry into force and no later than 30 June 1996. They shall forthwith inform the Commission thereof.

When the Member States adopt those measures they shall contain references to this Directive or shall be accompanied by such references on the occasion of their official publication. The methods of making such references shall be laid down by the Member States.

2. The Member States shall communicate to the Commission the texts of the main provisions of national law which they adopt in the field governed by this Directive.

Article 4

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Communities.*

Article 5

This Directive is addressed to the Member States.

Done at Brussels, 21 March 1996.

For the European Parliament
The President
K. HÄNSCH

For the Council
The President
A. GAMBINO

ANNEX

ANNEX II

The Treatment of Off-Balance-Sheet Items Concerning Interest and Foreign-Exchange Rates

1. Scope and Choice of Method

Subject to the consent of their competent authorities, credit institutions may choose one of the methods set out below to measure the risks associated with the transactions listed in Annex III. Interest-rate and foreign-exchange contracts traded on recognized exchanges where they are subject to daily margin requirements and foreign-exchange contracts with an original maturity of fourteen calendar days or less are excluded.

2. Methods

Method 1: the "mark-to-market" approach

Step (a): by attaching current market values to contracts (mark to market) the current replacement cost of all contracts with positive values is obtained.

Step (b): to obtain a figure for the potential future credit exposure,[7] the notional principal amounts or underlying values are multiplied by the following percentages:

TABLE 1

Residual maturity	Interest-rate contracts	Foreign-exchange contracts
One year or less	0%	1%
More than one year	0.5%	5%

Step (c): the sum of the current replacement cost and the potential future credit exposure is multiplied by the risk weightings allocated to the relevant counterparties in Article 6.

Method 2: the "original exposure" approach

Step (a): the notional principal amount of each instrument is multiplied by the percentages given below:

TABLE 2

Original maturity[1]	Interest-rate contracts	Foreign-exchange contracts
One year or less	0.5%	2%
More than one year but not exceeding two years	1%	5%
Additional allowance for each additional year	1%	3%

[1] In the case of interest-rate contracts, credit institutions may, subject to the consent of their competent authorities, choose either original or residual maturity.

Step (b): the original exposure thus obtained is multiplied by the risk weightings allocated to the relevant counterparties in Article 6.

3. Contractual Netting (Contracts for Novation and Other Netting Agreements)

(a) Types of netting that the competent authorities may recognize

[7] Except in the case of single-currency "floating/floating" interest-rate swaps in which only the current replacement cost will be calculated.

For the purposes of this point 3 "counterparty" means any entity (including natural persons) that has the power to conclude a contractual netting agreement.

The competent authorities may recognize as risk-reducing the following types of contractual netting:

(i) bilateral contracts for novation between a credit institution and its counterparty under which mutual claims and obligations are automatically amalgamated in such a way that this novation fixes one single net amount each time novation applies and thus creates a legally binding, single new contract extinguishing former contracts;

(ii) other bilateral netting agreements between a credit institution and its counterparty.

(b) Conditions for recognition

The competent authorities may recognize contractual netting as risk-reducing only under the following conditions:

(i) a credit institution must have a contractual netting agreement with its counterparty which creates a single legal obligation, covering all included transactions, such that, in the event of a counterparty's failure to perform owing to default, bankruptcy, liquidation or any other similar circumstance, the credit institution would have a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions;

(ii) a credit institution must have made available to the competent authorities written and reasoned legal opinions to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would, in the cases described under (i), find that the credit institution's claims and obligations would be limited to the net sum, as described in (i), under:

— the law of the jurisdiction in which the counterparty is incorporated and, if a foreign branch of an undertaking is involved, also under the law of the jurisdiction in which the branch is located,

— the law that governs the individual transactions included, and

— the law that governs any contract or agreement necessary to effect the contractual netting;

(iii) a credit institution must have procedures in place to ensure that the legal validity of its contractual netting is kept under review in the light of possible changes in the relevant laws.

The competent authorities must be satisfied, if necessary after consulting the other competent authorities concerned, that the contractual netting is legally valid under the law of each of the relevant jurisdictions. If any of the competent authorities is not satisfied in that respect, the contractual netting agreement will not be recognized as risk-reducing for either of the counterparties.

The competent authorities may accept reasoned legal opinions drawn up by types of contractual netting.

No contract containing a provision which permits a non-defaulting counterparty to make limited payments only, or no payments at all, to the estate of the defaulter, even if the defaulter is a net creditor (a "walkaway" clause), may be recognized as risk-reducing.

(c) Effects of recognition

(i) *Contracts for novation*

The single net amounts fixed by contracts for novation, rather than the gross amounts involved, may be weighted. Thus, in the application of Method 1, in

— Step (a): the current replacement cost, and in

— Step (b): the notional principal amounts or underlying values

may be obtained taking account of the contract for novation. In the application of Method 2, in Step (a) the notional principal amount may be calculated taking account of the contract for novation; the percentages of Table 2 must apply.

(ii) *Other netting agreements*

In the application of Method 1, in Step (a) the current replacement cost for the contracts included in a netting agreement may be obtained by taking account of the current hypothetical net replacement cost which results from the agreement. In Step (b) the single net amounts may be taken into account only for forward foreign-exchange contracts and other similar contracts, in which notional principal is equivalent to cash flows, in cases where the amounts to be claimed or delivered fall due on the same value date and in the same currency.

In the application of Method 2, in Step (a)

— for forward foreign-exchange contracts and other similar contracts, in which notional principal is equivalent to cash flows, in cases where the amounts to be claimed or delivered fall due on the same value date and in the same currency, the notional principal amount may be calculated taking account of the netting agreement; to all these contracts Table 2 must apply,

— for all other contracts included in a netting agreement, the percentages applicable may be reduced as indicated in Table 3:

TABLE 3

Original maturity[1]	Interest-rate contracts	Foreign-exchange contracts
One year or less	0.35%	1.50%
More than one year but not exceeding two years	0.75%	3.75%
Additional allowance for each additional year	0.75%	2.25%

[1] In the case of interest-rate contracts, credit institutions may, subject to the consent of their competent authorities, choose either original or residual maturity.

Appendix V
U. S. Legislation

Appendix V

1 The Right to Financial Privacy Act[1]

[Excerpts][2]

Section 3402. Access to financial records by Government authorities prohibited; exceptions

Except as provided by section 3403(c) or (d), 3413, or 3414 of this title, no Government authority may have access to or obtain copies of, or the information contained in the financial records of any customer from a financial institution unless the financial records are reasonably described and—

(1) such customer has authorized such disclosure in accordance with section 3404 of this title;

(2) such financial records are disclosed in response to an administrative subpena or summons which meets the requirements of section 3405 of this title;

(3) such financial records are disclosed in response to a search warrant which meets the requirements of section 3406 of this title;

(4) such financial records are disclosed in response to a judicial subpena which meets the requirements of section 3407 of this title; or

(5) such financial records are disclosed in response to a formal written request which meets the requirements of section 3408 of this title.

Section 3403. Confidentiality of financial records

(a) Release of records by financial institutions prohibited

No financial institution, or officer, employees, or agent of a financial institution, may provide to any Government authority access to or copies of, or the information contained in, the financial records of any customer except in accordance with the provisions of this chapter.

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[1]Footnotes and references have been omitted.

[2]The Right to Financial Privacy Act is in sections 3401 to 3422 of title 12 of the United States Code. The provisions reproduced here are as of 1996.

(b) **Release of records upon certification of compliance with chapter**

A financial institution shall not release the financial records of a customer until the Government authority seeking such records certifies in writing to the financial institution that it has complied with the applicable provisions of this chapter.

(c) **Notification to Government authority of existence of relevant information in records**

Nothing in this chapter shall preclude any financial institution, or any officer, employee, or agent of a financial institution, from notifying a Government authority that such institution, or officer, employee, or agent has information which may be relevant to a possible violation of any statute or regulation. Such information may include only the name or other identifying information concerning any individual, corporation, or account involved in and the nature of any suspected illegal activity. Such information may be disclosed notwithstanding any constitution, law, or regulation of any State or political subdivision thereof to the contrary. Any financial institution, or officer, employee, or agent thereof, making a disclosure of information pursuant to this subsection, shall not be liable to the customer under any law or regulation of the United States or any constitution, law, or regulation of any State or political subdivision thereof, for such disclosure or for any failure to notify the customer of such disclosure.

(d) **Release of records as incident to perfection of security interest, proving a claim in bankruptcy, collecting a debt, or proessing an application with regard to a Government loan, loan guarantee, etc.**

(1) Nothing in this chapter shall preclude a financial institution, as an incident to perfecting a security interest, proving a claim in bankruptcy, or otherwise collecting on a debt owing either to the financial institution itself or in its role as a fiduciary, from providing copies of any financial record to any court or Government authority.

(2) Nothing in this chapter shall preclude a financial institution, as an incident to processing an application for assistance to a customer in the form of a Government loan, loan guaranty, or loan insurance agreement, or as an incident to processing a default on, or administering, a Government guaranteed or insured loan, from initiating contact with an appropriate Government authority for the purpose of providing any financial record necessary to permit such authority to carry out its responsibilities under a loan, loan guaranty, or loan insurance agreement.

Section 3404. Customer authorizations

(a) **Statement furnished by customer to financial institution and Government authority; contents**

A customer may authorize disclosure under section 3402(1) of this title if he furnishes to the financial institution and to the Government authority seeking to obtain such disclosure a signed and dated statement which—

(1) authorizes such disclosure for a period not in excess of three months;

(2) states that the customer may revoke such authorization at any time before the financial records are disclosed;

(3) identifies the financial records which are authorized to be disclosed;

(4) specifies the purposes for which, and the Government authority to which, such records may be disclosed; and

(5) states the customer's rights under this chapter.

(b) **Authorization as condition of doing business prohibited**

No such authorization shall be required as a condition of doing business with any financial institution.

(c) **Right of customer to access to financial institution's record of disclosures**

The customer has the right, unless the Government authority obtains a court order as provided in section 3409 of this title, to obtain a copy of the record which the financial institution shall keep of all instances in which the customer's record is disclosed to a Government authority pursuant to this section, including the identity of the Government authority to which such disclosure is made.

Section 3409. Delayed notice

(a) **Application by Government authority; findings**

Upon application of the Government authority, the customer notice required under section 3404(c), 3405(2), 3406(c), 3407(2), 3408(4), or 3412(b) of this title may be delayed by order of an appropriate court if the presiding judge or magistrate finds that—

(1) the investigation being conducted is within the lawful jurisdiction of the Government authority seeking the financial records;

(2) there is reason to believe that the records being sought are relevant to a legitimate law enforcement inquiry; and

(3) there is reason to believe that such notice will result in—

(A) endangering life or physical safety of any person;

(B) flight from prosecution;

(C) destruction of or tampering with evidence;

(D) intimidation of potential witnesses; or

(E) otherwise seriously jeopardizing an investigation or official proceeding or unduly delaying a trial or ongoing official proceeding to the same extent as the circumstances in the preceding subparagraphs.

An application for delay must be made with reasonable specificity.

(b) **Grant of delay order; duration and specifications; extensions; copy of request and notice to customer**

(1) If the court makes the findings required in paragraphs (1), (2), and (3) of subsection (a) of this section, it shall enter an ex parte order granting the requested delay for a period not to exceed ninety days and an order prohibiting the financial institution from disclosing that records have been obtained or that a request for records has been made, except that, if the records have been sought by a Government authority exercising financial controls over foreign accounts in the United States under section 5(b) of the Trading With the Enemy Act [12 U.S.C. 95a, 50 App. U.S.C. 5(b)], the International Emergency Economic Powers Act (title II, Public Law 95–223) [50 U.S.C. 1701 et seq.], or section 287c of title 22, and the court finds that there is reason to believe that such notice may endanger the lives or physical safety of a customer or group of customers, or any person or group of persons associated with a customer, the court may specify that the delay be indefinite.

(2) Extensions of the delay of notice provided in paragraph (1) of up to ninety days each may be granted by the court upon application, but only in accordance with this subsection.

(3) Upon expiration of the period of delay of notification under paragraph (1) or (2), the customer shall be served with or mailed a copy of the process or request together with the following notice which shall state with reasonable specificity the nature of the law enforcement inquiry:

"Records or information concerning your transactions which are held by the financial institution named in the attached process or request were supplied to or requested by the Government authority named in the

process or request on (date). Notification was withheld pursuant to a determination by the (title of court so ordering) under the Right to Financial Privacy Act of 1978 [12 U.S.C. 3401 et seq.] that such notice might (state reason).

The purpose of the investigation or official proceeding was .".

(c) **Notice requirement respecting emergency access to financial records**

When access to financial records is obtained pursuant to section 3414(b) of this title (emergency access), the Government authority shall, unless a court has authorized delay of notice pursuant to subsections (a) and (b) of this section, as soon as practicable after such records are obtained serve upon the customer, or mail by registered or certified mail to his last known address, a copy of the request to the financial institution together with the following notice which shall state with reasonable specificity the nature of the law enforcement inquiry:

"Records concerning your transactions held by the financial institution named in the attached request were obtained by (agency or department) under the Right to Financial Privacy Act of 1978 [12 U.S.C. 3401 et seq.] on (date) for the following purpose: Emergency access to such records was obtained on the grounds that (state grounds).".

(d) **Preservation of memorandums, affidavits, or other papers**

Any memorandum, affidavit, or other paper filed in connection with a request for delay in notification shall be preserved by the court. Upon petition by the customer to whom such records pertain, the court may order disclosure of such papers to the petitioner unless the court makes the findings required in subsection (a) of this section.

Section 3412. Use of information

(a) **Transfer of financial records to other agencies or departments; certification**

Financial records originally obtained pursuant to this chapter shall not be transferred to another agency or department unless the transferring agency or department certifies in writing that there is reason to believe that the records are relevant to a legitimate law enforcement inquiry within the jurisdiction of the receiving agency or department.

(b) **Mailing of copy of certification and notice to customer**

When financial records subject to this chapter are transferred pursuant to subsection (a) of this section, the transferring agency or department

shall, within fourteen days, send to the customer a copy of the certification made pursuant to subsection (a) of this section and the following notice, which shall state the nature of the law enforcement inquiry with reasonable specificity: "Copies of, or information contained in, your financial records lawfully in possession of have been furnished to pursuant to the Right of Financial Privacy Act of 1978 [12 U.S.C. 3401 et seq.] for the following purpose: If you believe that this transfer has not been made to further a legitimate law enforcement inquiry, you may have legal rights under the Financial Privacy Act of 1978 or the Privacy Act of 1974 [5 U.S.C. 552a]."

(c) **Court-ordered delays in mailing**

Notwithstanding subsection (b) of this section, notice to the customer may be delayed if the transferring agency or department has obtained a court order delaying notice pursuant to section 3409(a) and (b) of this title and that order is still in effect, or if the receiving agency or department obtains a court order authorizing a delay in notice pursuant to section 3409(a) and (b) of this title. Upon the expiration of any such period of delay, the transferring agency or department shall serve to the customer the notice specified in subsection (b) of this section and the agency or department that obtained the court order authorizing a delay in notice pursuant to section 3409(a) and (b) of this title shall serve to the customer the notice specified in section 3409(b) of this title.

(d) **Exchanges of examination reports by supervisory agencies; transfer of financial records to defend customer action; withholding of information**

Nothing in this chapter prohibits any supervisory agency from exchanging examination reports or other information with another supervisory agency. Nothing in this chapter prohibits the transfer of a customer's financial records needed by counsel for a Government authority to defend an action brought by the customer. Nothing in this chapter shall authorize the withholding of information by any officer or employee of a supervisory agency from a duly authorized committee or subcommittee of the Congress.

(e) **Federal Financial Institutions Examination Council supervisory agencies; Securities and Exchange Commission; authorization of exchange of financial records or other information**

Notwithstanding section 3401(6) of this title or any other provision of this chapter, the exchange of financial records or other information with respect to a financial institution, holding company, or any subsidiary of a depository institution or holding company, among and between the five member supervisory agencies of the Federal Financial Institutions

Examination Council and the Securities and Exchange Commission is permitted.

(f) **Transfer to Attorney General**

(1) In general

Nothing in this chapter shall apply when financial records obtained by an agency or department of the United States are disclosed or transferred to the Attorney General or the Secretary of the Treasury upon the certification by a supervisory level official of the transferring agency or department that—

(A) there is reason to believe that the records may be relevant to a violation of Federal criminal law; and

(B) the records were obtained in the exercise of the agency's or department's supervisory or regulatory functions.

(2) Limitation on use

Records so transferred shall be used only for criminal investigative or prosecutive purposes, for civil actions under section 1833a of this title, or for forfeiture under sections 981 or 982 of title 18 by the Department of Justice and only for criminal investigative purposes relating to money laundering and other financial crimes by the Department of the Treasury and shall, upon completion of the investigation or prosecution (including any appeal), be returned only to the transferring agency or department. No agency or department so transferring such records shall be deemed to have waived any privilege applicable to those records under law.

Section 3413. Exceptions

(a) **Disclosure of financial records not identified with particular customers**

Nothing in this chapter prohibits the disclosure of any financial records or information which is not identified with or identifiable as being derived from the financial records of a particular customer.

(b) **Disclosure to, or examination by, supervisory agency pursuant to exercise of supervisory, regulatory, or monetary functions with respect to financial institutions, holding companies, subsidiaries, institution-affiliated parties, or other persons**

This chapter shall not apply to the examination by or disclosure to any supervisory agency of financial records or information in the exercise of its supervisory, regulatory, or monetary functions, including conservatorship or receivership functions, with respect to any financial institution, holding

company, subsidiary of a financial institution or holding company, institution-affiliated party (within the meaning of section 1813(u) of this title) with respect to a financial institution, holding company, or subsidiary, or other person participating in the conduct of the affairs thereof.

(c) **Disclosure pursuant to title 26**

Nothing in this chapter prohibits the disclosure of financial records in accordance with procedures authorized by title 26.

(d) **Disclosure pursuant to Federal statute or rule promulgated thereunder**

Nothing in this chapter shall authorize the withholding of financial records or information required to be reported in accordance with any Federal statute or rule promulgated thereunder.

(e) **Disclosure pursuant to Federal Rules of Criminal Procedure or comparable rules of other courts**

Nothing in this chapter shall apply when financial records are sought by a Government authority under the Federal Rules of Civil or Criminal Procedure or comparable rules of other courts in connection with litigation to which the Government authority and the customer are parties.

(f) **Disclosure pursuant to administrative subpoena issued by administrative law judge**

Nothing in this chapter shall apply when financial records are sought by a Government authority pursuant to an administrative subpena issued by an administrative law judge in an adjudicatory proceeding subject to section 554 of title 5 and to which the Government authority and the customer are parties.

(g) **Disclosure pursuant to legitimate law enforcement inquiry respecting name, address, account number, and type of account of particular customers**

The notice requirements of this chapter and sections 3410 and 3412 of this title shall not apply when a Government authority by a means described in section 3402 of this title and for a legitimate law enforcement inquiry is seeking only the name, address, account number, and type of account of any customer or ascertainable group of customers associated (1) with a financial transaction or class of financial transactions, or (2) with a foreign country or subdivision thereof in the case of a Government authority exercising financial controls over foreign accounts in the United States under section 5(b) of the Trading with the Enemy Act [12 U.S.C. 95a, 50 App. U.S.C. 5(b)]; the International Emergency Economic Powers Act (title II, Public Law 95-223) [50 U.S.C. 1701 et seq.]; or section 287c of title 22.

* * * * *

(l) **Crimes against financial institutions by insiders**

Nothing in this chapter shall apply when any financial institution or supervisory agency provides any financial record of any officer, director, employee, or controlling shareholder (within the meaning of subparagraph (A) or (B) of section 1841(a)(2) of this title or subparagraph (A) or (B) of section 1730a(a)(2) of this title) of such institution, or of any major borrower from such institution who there is reason to believe may be acting in concert with any such officer, director, employee, or controlling shareholder, to the Attorney General of the United States, to a State law enforcement agency, or, in the case of a possible violation of subchapter II of chapter 53 of title 31, to the Secretary of the Treasury if there is reason to believe that such record is relevant to a possible violation by such person of—

(1) any law relating to crimes against financial institutions or supervisory agencies by directors, officers, employees, or controlling shareholders of, or by borrowers from, financial institutions; or

(2) any provision of subchapter II of chapter 53 of title 31 or of section 1956 or 1957 of title 18.

No supervisory agency which transfers any such record under this subsection shall be deemed to have waived any privilege applicable to that record under law.

(m) **Disclosure to, or examination by, employees or agents of Board of Governors of Federal Reserve System or Federal Reserve Bank**

This chapter shall not apply to the examination by or disclosure to employees or agents of the Board of Governors of the Federal Reserve System or any Federal Reserve Bank of financial records or information in the exercise of the Federal Reserve System's authority to extend credit to the financial institutions or others.

(n) **Disclosure to, or examination by, Resolution Trust Corporation or its employees or agents**

This chapter shall not apply to the examination by or disclosure to the Resolution Trust Corporation or its employees or agents of financial records or information in the exercise of its conservatorship, receivership, or liquidation functions with respect to a financial institution.

(o) **Disclosure to, or examination by, Federal Housing Finance Board or Federal home loan banks**

This chapter shall not apply to the examination by or disclosure to the Federal Housing Finance Board or any of the Federal home loan banks

of financial records or information in the exercise of the Federal Housing Finance Board's authority to extend credit (either directly or through a Federal home loan bank) to financial institutions or others.

Section 3414. Special procedures

(a)(1) Nothing in this chapter (except sections 3415, 3417, 3418, and 3421 of this title) shall apply to the production and disclosure of financial records pursuant to requests from—

(A) a Government authority authorized to conduct foreign counter- or foreign positive-intelligence activities for purposes of conducting such activities; or

(B) the Secret Service for the purpose of conducting its protective functions (18 U.S.C. 3056; 3 U.S.C. 202, Public Law 90-331, as amended).

(2) In the instances specified in paragraph (1), the Government authority shall submit to the financial institution the certificate required in section 3403(b) of this title signed by a supervisory official of a rank designated by the head of the Government authority.

(3) No financial institution, or officer, employee, or agent of such institution, shall disclose to any person that a Government authority described in paragraph (1) has sought or obtained access to a customer's financial records.

(4) The Government authority specified in paragraph (1) shall compile an annual tabulation of the occasions in which this section was used.

(5)(A) Financial institutions, and officers, employees, and agents thereof, shall comply with a request for a customer's or entity's financial records made pursuant to this subsection by the Federal Bureau of Investigation when the Director of the Federal Bureau of Investigation (or the Director's designee) certifies in writing to the financial institution that such records are sought for foreign counterintelligence purposes and that there are specific and articulable facts giving reason to believe that the customer or entity whose records are sought is a foreign power or an agent of a foreign power as defined in section 1801 of title 50.

(B) The Federal Bureau of Investigation may disseminate information obtained pursuant to this paragraph only as provided in guidelines approved by the Attorney General for foreign intelligence collection and foreign counterintelligence investigations conducted by the Federal Bureau of Investigation, and, with respect to dissemination to an

agency of the United States, only if such information is clearly relevant to the authorized responsibilities of such agency.

(C) On a semiannual basis the Attorney General shall fully inform the Permanent Select Committee on Intelligence of the House of Representatives and the Select Committee on Intelligence of the Senate concerning all requests made pursuant to this paragraph.

(D) No financial institution, or officer, employee, or agent of such institution, shall disclose to any person that the Federal Bureau of Investigation has sought or obtained access to a customer's or entity's financial records under this paragraph.

(b)(1) Nothing in this chapter shall prohibit a Government authority from obtaining financial records from a financial institution if the Government authority determines that delay in obtaining access to such records would create imminent danger of—

(A) physical injury to any person;

(B) serious property damage; or

(C) flight to avoid prosecution.

(2) In the instances specified in paragraph (1), the Government shall submit to the financial institution the certificate required in section 3403(b) of this title signed by a supervisory official of a rank designated by the head of the Government authority.

(3) Within five days of obtaining access to financial records under this subsection, the Government authority shall file with the appropriate court a signed, sworn statement of a supervisory official of a rank designated by the head of the Government authority setting forth the grounds for the emergency access. The Government authority shall thereafter comply with the notice provisions of section 3409(c) of this title.

(4) The Government authority specified in paragraph (1) shall compile an annual tabulation of the occasions in which this section was used.

Section 3417. Civil penalties

(a) **Liability of agencies or departments of United States or financial institutions**

Any agency or department of the United States or financial institution obtaining or disclosing financial records or information contained therein in violation of this chapter is liable to the customer to whom such records relate in an amount equal to the sum of—

(1) $100 without regard to the volume of records involved;

(2) any actual damages sustained by the customer as a result of the disclosure;

(3) such punitive damages as the court may allow, where the violation is found to have been willful or intentional; and

(4) in the case of any successful action to enforce liability under this section, the costs of the action together with reasonable attorney's fees as determined by the court.

(b) **Disciplinary action for willful or intentional violation of chapter by agents or employees of department or agency**

Whenever the court determines that any agency or department of the United States has violated any provision of this chapter and the court finds that the circumstances surrounding the violation raise questions of whether an officer or employee of the department or agency acted willfully or intentionally with respect to the violation, the Director of the Office of Personnel Management shall promptly initiate a proceeding to determine whether disciplinary action is warranted against the agent or employee who was primarily responsible for the violation. The Director after investigation and consideration of the evidence submitted, shall submit his findings and recommendations to the administrative authority of the agency concerned and shall send copies of the findings and recommendations to the officer or employee or his representative. The administrative authority shall take the corrective action that the Director recommends.

(c) **Good faith defense**

Any financial institution or agent or employee thereof making a disclosure of financial records pursuant to this chapter in good-faith reliance upon a certificate by any Government authority or pursuant to the provisions of section 3413(*l*) of this title shall not be liable to the customer for such disclosure under this chapter, the constitution of any State, or any law or regulation of any State or any political subdivision of any State.

(d) **Exclusive judicial remedies and sanctions**

The remedies and sanctions described in this chapter shall be the only authorized judicial remedies and sanctions for violations of this chapter.

Appendix V

2 U.S. Regulations on Financial Record Keeping and Reporting of Currency and Foreign Transactions

[Excerpts][1]

Section 103.21 Reports by banks of suspicious transactions.

(a) *General.* (1) Every bank shall file with the Treasury Department, to the extent and in the manner required by this section, a report of any suspicious transaction relevant to a possible violation of law or regulation. A bank may also file with the Treasury Department by using the Suspicious Activity Report specified in paragraph (b)(1) of this section or otherwise, a report of any suspicious transaction that it believes is relevant to the possible violation of any law or regulation but whose reporting is not required by this section.

(2) A transaction requires reporting under the terms of this section if it is conducted or attempted by, at, or through the bank, it involves or aggregates at least $5,000 in funds or other assets, and the bank knows, suspects, or has reason to suspect that:

(i) The transaction involves funds derived from illegal activities or is intended or conducted in order to hide or disguise funds or assets derived from illegal activities (including, without limitation, the ownership, nature, source, location, or control of such funds or assets) as part of a plan to violate or evade any federal law or regulation or to avoid any transaction reporting requirement under federal law or regulation;

(ii) The transaction is designed to evade any requirements of this part or of any other regulations promulgated under the Bank Secrecy Act, Pub. L. 91-508, as amended, codified at 12 U.S.C. 1829b, 12 U.S.C. 1951-1959, and 31 U.S.C. 5311-5330; or

(iii) The transaction has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the bank knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

[1]This text consists of excerpts of Part 103—Financial Recordkeeping and Reporting of Currency and Foreign Transactions, 31 Code of Federal Regulations (1997).

(b) *Filing procedures.* (1) *What to file.* A suspicious transaction shall be reported by completing a Suspicious Activity Report ("SAR"), and collecting and maintaining supporting documentation as required by paragraph (d) of this section.

(2) *Where to file.* The SAR shall be filed with FinCEN in a central location, to be determined by FinCEN, as indicated in the instructions to the SAR.

(3) *When to file.* A bank is required to file a SAR no later than 30 calendar days after the date of initial detection by the bank of facts that may constitute a basis for filing a SAR. If no suspect was identified on the date of the detection of the incident requiring the filing, a bank may delay filing a SAR for an additional 30 calendar days to identify a suspect. In no case shall reporting be delayed more than 60 calendar days after the date of initial detection of a reportable transaction. In situations involving violations that require immediate attention, such as, for example, ongoing money laundering schemes, the bank shall immediately notify, by telephone, an appropriate law enforcement authority in addition to filing timely a SAR.

(c) *Exceptions.* A bank is not required to file a SAR for a robbery or burglary committed or attempted that is reported to appropriate law enforcement authorities, or for lost, missing, counterfeit, or stolen securities with respect to which the bank files a report pursuant to the reporting requirements of 17 CFR 240.17f–1.

(d) *Retention of records.* A bank shall maintain a copy of any SAR filed and the original or business record equivalent of any supporting documentation for a period of five years from the date of filing the SAR. Supporting documentation shall be identified, and maintained by the bank as such, and shall be deemed to have been filed with the SAR. A bank shall make all supporting documentation available to FinCEN and any appropriate law enforcement agencies or bank supervisory agencies upon request.

(e) *Confidentiality of reports; limitation of liability.* No bank or other financial institution, and no director, officer, employee, or agent of any bank or other financial institution, who reports a suspicious transaction under this part, may notify any person involved in the transaction that the transaction has been reported. Thus, any person subpoenaed or otherwise requested to disclose a SAR or the information contained in a SAR, except where such disclosure is requested by FinCEN or an appropriate law enforcement or bank supervisory agency, shall decline to produce the SAR or to provide any information that would disclose that a SAR has been prepared or filed, citing this paragraph (e) and 31 U.S.C. 5318(g)(2), and

shall notify FinCEN of any such request and its response thereto. A bank, and any director, officer, employee, or agent of such bank, that makes a report pursuant to this section (whether such report is required by this section or is made voluntarily) shall be protected from liability for any disclosure contained in, or for failure to disclose the fact of such report, or both, to the full extent provided by 31 U.S.C. 5318(g)(3).

(f) *Compliance.* Compliance with this section shall be audited by the Department of the Treasury, through FinCEN or its delegees under the terms of the Bank Secrecy Act. Failure to satisfy the requirements of this section may be a violation of the reporting rules of the Bank Secrecy Act and of this part. Such failure may also violate provisions of Title 12 of the Code of Federal Regulations.

Section 103.22 Reports of currency transactions.

(a)(1) Each financial institution other than a casino or the Postal Service shall file a report of each deposit, withdrawal, exchange of currency or other payment or transfer, by, through, or to such financial institution which involves a transaction in currency of more than $10,000. Transactions in currency by exempt persons with banks occurring after April 30, 1996, are not subject to this requirement to the extent provided in paragraph (h) of this section. Multiple currency transactions shall be treated as a single transaction if the financial institution has knowledge that they are by or on behalf of any person and result in either cash in or cash out totaling more than $10,000 during any one business day. Deposits made at night or over a weekend or holiday shall be treated as if received on the next business day following the deposit.

(2) Each casino shall file a report of each transaction in currency, involving either cash in or cash out, of more than $10,000.

(i) Transactions in currency involving cash in include, but are not limited to:

(A) Purchases of chips, tokens, and plaques;

(B) Front money deposits;

(C) Safekeeping deposits;

(D) Payments on any form of credit, including markers and counter checks;

(E) Bets of currency;

(F) Currency received by a casino for transmittal of funds through wire transfer for a customer;

(G) Purchases of a casino's check; and

(H) Exchanges of currency for currency, including foreign currency.

(ii) Transactions in currency involving cash out include, but are not limited to:

(A) Redemptions of chips, tokens, and plaques;

(B) Front money withdrawals;

(C) Safekeeping withdrawals;

(D) Advances on any form of credit, including markers and counter checks;

(E) Payments on bets, including slot jackpots;

(F) Payments by a casino to a customer based on receipt of funds through wire transfer for credit to a customer;

(G) Cashing of checks or other negotiable instruments;

(H) Exchanges of currency for currency, including foreign currency; and

(I) Reimbursements for customers' travel and entertainment expenses by the casino.

(iii) Multiple currency transactions shall be treated as a single transaction if the casino has knowledge that they are by or on behalf of any person and result in either cash in or cash out totaling more than $10,000 during any gaming day. For purposes of this paragraph (a)(2), a casino shall be deemed to have the knowledge described in the preceding sentence, if: any sole proprietor, partner, officer, director, or employee of the casino, acting within the scope of his or her employment, has knowledge that such multiple currency transactions have occurred, including knowledge from examining the books, records, logs, information retained on magnetic disk, tape or other machine-readable media, or in any manual system, and similar documents and information, which the casino maintains pursuant to any law or regulation or within the ordinary course of its business, and which contain information that such multiple currency transactions have occurred.

(3) The Postal Service shall file a report of each cash purchase of postal money orders in excess of $10,000. Multiple cash purchases totaling more than $10,000 shall be treated as a single transaction if the Postal Service has knowledge that they are by or on behalf of any person during any one day.

(4) A financial institution includes all of its domestic branch offices for the purpose of this paragraph's reporting requirements.

(b) Except as otherwise directed in writing by the Assistant Secretary (Enforcement) or the Commissioner of Internal Revenue:

(1) This section shall not require reports:

(i) Of transactions with Federal Reserve Banks or Federal Home Loan banks;

(ii) Of transactions between domestic banks; or

(iii) By nonbank financial institutions of transactions with commercial banks (however, commercial banks must report such transactions with nonbank financial institutions).

(2) A bank may exempt from the reporting requirement of paragraph (a) of this section the following:

(i) Deposits or withdrawals of currency from an existing account by an established depositor who is a United States resident and operates a retail type of business in the United States. For the purpose of this subsection, a retail type of business is a business primarily engaged in providing goods to ultimate consumers and for which the business is paid in substantial portions by currency, except that dealerships which buy or sell motor vehicles, vessels, or aircraft are not included and their transactions may not be exempted from the reporting requirements of this section.

(ii) Deposits or withdrawals of currency from an existing account by an established depositor who is a United States resident and operates a sports arena, race track, amusement park, bar, restaurant, hotel, check cashing service licensed by state or local governments, vending machine company, theater, regularly scheduled passenger carrier or any public utility.

(iii) Deposits or withdrawals, exchanges of currency or other payments and transfers by local or state governments, or the United States or any of its agencies or instrumentalities.

(iv) Withdrawals for payroll purposes from an existing account by an established depositor who is a United States resident and operates a firm that regularly withdraws more than $10,000 in order to pay its employees in currency.

(c) In each instance the transactions exempted under paragraph (b) of this section must be in amounts which the bank may reasonably conclude do not exceed amounts commensurate with the customary conduct of

the lawful, domestic business of that customer, or in the case of transactions with a local or state government or the United States or any of its agencies or instrumentalities, in amounts which are customary and commensurate with the authorized activities of the agency or instrumentality. This section does not permit a bank to exempt its transactions with nonbank financial institutions (except for check cashing services licensed by state or local governments and the United States Postal Service) nor will additional exemption authority be granted for such transaction (except transactions by other check cashers).

(d) After October 27, 1986, a bank may not place any customer on its exempt list without first preparing a written statement, signed by the customer, describing the customary conduct of the lawful domestic business of that customer and a detailed statement of reasons why such person is qualified for an exemption. The statement shall include the name, address, nature of business, taxpayer identification number, and account number of the customer being exempted. The signature, including the title and position of the person signing, will attest to the accuracy of the information concerning the name, address, nature of business, and tax identification number of the customer. Immediately above the signature line, the following statement shall appear:

"The information contained above is true and correct to the best of my knowledge and belief. I understand that this information will be read and relied upon by the Government."

The bank shall indicate in this statement whether the exemption covers withdrawals, deposits, or both, as well as the dollar limit of the exemption for both deposits and withdrawals. The bank also shall indicate whether the exemption is limited to certain types of deposits and withdrawals (*e.g.*, withdrawals for payroll purposes). In each instance, the exempted transactions must be in amounts that the bank may reasonably conclude do not exceed amounts commensurate with the customary conduct of the lawful domestic business of that customer. The bank is responsible for independently verifying the activity of the account and determining applicable dollar limits for exempted deposits or withdrawals. The bank must retain each statement that it prepares pursuant to this subparagraph as long as the customer is on the exempt list, and for a period of five years following removal of the customer from the bank's exempt list.

(e) A bank may apply to the Commissioner of Internal Revenue for additional authority to grant an exemption to the reporting requirement, not otherwise permitted under paragraph (b) of this section, if the bank believes that circumstances warrant such an exemption. Such requests shall be addressed to: Chief, Currency and Banking Reports Branch,

Compliance Review Group, IRS Data Center, Post Office Box 32063, Detroit, Michigan 48232, and must be accompanied by a statement of the circumstances that warrant special exemption treatment and a copy of the statement signed by the customer required by paragraph (d) of this section.

(f) A record of each exemption granted under this section and the reason therefor must be kept in a centralized list. The record shall include the names and addresses of all banks referred to in paragraph (b)(1)(ii) of this section, as well as the name, address, business, taxpayer identification number and account number of each depositor that has engaged in currency transactions which have not been reported because of the exemption provided in paragraph (b)(2) of this section. The record concerning the group of depositors exempted under the provisions of paragraph (b)(2) of this section shall also indicate whether the exemption covers withdrawals, deposits, or both, as well as the dollar limit of the exemption.

(g) Upon the request of the Assistant Secretary (Enforcement) or the Commissioner of Internal Revenue, a bank shall provide a report containing the list of the bank's customers whose transactions have been exempted under this section and such related information as the Assistant Secretary or Commissioner shall require, including copies of the statements required in paragraph (d) of this section. The report must be provided within 15 days of the request. Any exemption may be rescinded at the discretion of the requesting official, who may require the bank to file reports required by paragraph (a) of this section with respect to future transactions of any customer whose transactions previously were exempted.

(h) *No filing required by banks for transactions by exempt persons occurring after April 30, 1996*—(1) *Currency transactions of exempt persons with banks occurring after April 30, 1996.* Notwithstanding the provisions of paragraph (a)(1) of this section, no bank is required to file a report otherwise required by paragraph (a)(1) of this section, with respect to any transaction in currency between an exempt person and a bank that is conducted after April 30, 1996.

(2) *Exempt person.* For purposes of this section, an exempt person is:

(i) A bank, to the extent of such bank's domestic operations;

(ii) A department or agency of the United States, of any state, or of any political subdivision of any state;

(iii) Any entity established under the laws of the United States, of any state, or of any political subdivision of any state, or under an interstate compact between two or more states, that exercises governmental

authority on behalf of the United States or any such state or political subdivision;

(iv) Any corporation whose common stock is listed on the New York Stock Exchange or the American Stock Exchange (except stock listed on the Emerging Company Marketplace of the American Stock Exchange) or whose common stock has been designated as a Nasdaq National Market Security listed on the Nasdaq Stock Market (except stock listed under the separate "Nasdaq Small-Cap Issues" heading); and

(v) Any subsidiary of any corporation described in paragraph (h)(2)(iv) of this section whose federal income tax return is filed as part of a consolidated federal income tax return with such corporation, pursuant to section 1501 of the Internal Revenue Code and the regulations promulgated thereunder, for the calendar year 1995 or for its last fiscal year ending before April 15, 1996.

(3) *Designation of exempt persons.* (i) A bank must designate each exempt person with whom it engages in transactions in currency, on or before the later of August 15, 1996, and the date 30 days following the first transaction in currency between such bank and such exempt person that occurs after April 30, 1996.

(ii) Designation of an exempt person shall be made by a single filing of Internal Revenue Service Form 4789, in which line 36 is marked "Designation of Exempt Person" and items 2–14 (Part I, Section A) and items 37–49 (Part III) are completed. The designation must be made separately by each bank that treats the person in question as an exempt person. (For availability, see 26 CFR 601.602.)

(iii) This designation requirement applies whether or not the particular exempt person to be designated has previously been treated as exempt from the reporting requirements of paragraph (a) of this section under the rules contained in paragraph (b) or (e) of this section.

(4) *Operating rules for designating exempt persons.* (i) Subject to the specific rules of this paragraph (h), a bank must take such steps to assure itself that a person is an exempt person (within the meaning of applicable provisions of paragraph (h)(2) of this section) that a reasonable and prudent bank would take to protect itself from loan or other fraud or loss based on misidentification of a person's status.

(ii) A bank may treat a person as a governmental department, agency, or entity if the name of such person reasonably indicates that it is described in paragraph (h)(2)(ii) or (h)(2)(iii) of this section, or if such person is known generally in the community to be a State, the District of Columbia, a tribal government, a Territory or Insular Possession of the

United States, or a political subdivision or a wholly-owned agency or instrumentality of any of the foregoing. An entity generally exercises governmental authority on behalf of the United States, a State, or a political subdivision, for purposes of paragraph (h)(2)(iii) of this section, only if its authorities include one or more of the powers to tax, to exercise the authority of eminent domain, or to exercise police powers with respect to matters within its jurisdiction.

(iii) In determining whether a person is described in paragraph (h)(2)(iv) of this section, a bank may rely on any New York Stock Exchange, American Stock Exchange, or Nasdaq Stock Market listing published in a newspaper of general circulation and on any commonly accepted or published stock symbol guide.

(iv) In determining whether a person is described in paragraph (h)(2)(v) of this section, a bank may rely upon any reasonably authenticated corporate officer's certificate or any reasonably authenticated photocopy of Internal Revenue Service Form 851 (Affiliation Schedule) or the equivalent thereof for the appropriate tax year.

(5) *Limitation on exemption.* A transaction carried out by an exempt person as an agent for another person who is the beneficial owner of the funds that are the subject of a transaction in currency is not subject to the exemption from reporting contained in paragraph (h)(1) of this section.

(6) *Effect of exemption; limitation on liability.* (i) FinCEN may in the future determine by amendment to this part that the exemption contained in this paragraph (h) shall be the only basis for exempting persons described in paragraph (h)(2) of this section from the reporting requirements of paragraph (a) of this section.

(ii) No bank shall be subject to penalty under this part for failure to file a report required by paragraph (a) of this section with respect to a currency transaction by an exempt person with respect to which the requirements of this paragraph (h) have been satisfied, unless the bank:

(A) Knowingly files false or incomplete information with respect to the transaction or the customer engaging in the transaction; or

(B) Has reason to believe at the time the exemption is granted that the customer does not meet the criteria established by this paragraph (h) for treatment of the transactor as an exempt person or that the transaction is not a transaction of the exempt person.

(iii) A bank that files a report with respect to a currency transaction by an exempt person rather than treating such person as exempt shall remain subject with respect to each such report to the rules for filing

reports, and the penalties for filing false or incomplete reports, that are applicable to reporting of transactions in currency by persons other than exempt persons. A bank that continues for the period permitted by paragraph (h)(6)(i) of this section to treat a person described in paragraph (h)(2) of this section as exempt from the reporting requirements of paragraph (a) of this section on a basis other than as provided in this paragraph (h) shall remain subject in full to the rules governing an exemption on such other basis and to the penalties for failing to comply with the rules governing such other exemption.

(7) *Obligation to file suspicious activity reports, etc.* Nothing in this paragraph (h) relieves a bank of the obligation, or alters in any way such bank's obligation, to file a report required by § 103.21 with respect to any transaction, including, without limitation, any transaction in currency, or relieves a bank of any other reporting or recordkeeping obligation imposed by this part (except the obligation to report transactions in currency pursuant to paragraph (a) of this section to the extent provided in this paragraph (h)).

(8) *Revocation.* The status of any person as an exempt person under this paragraph (h) may be revoked by FinCEN by written notice, which may be provided by publication in the Federal Register in appropriate situations, on such terms as are specified in such notice. In addition, and without any action on the part of the Treasury Department:

(i) The status of a corporation as an exempt person pursuant to paragraph (h)(2)(iv) of this section ceases once such corporation ceases to be listed on the applicable stock exchange; and

(ii) The status of a subsidiary as an exempt person under paragraph (h)(2)(v) of this section ceases once such subsidiary ceases to be included in a consolidated federal income tax return of a person described in paragraph (h)(2)(iv) of this section.

Section 103.23 Reports of transportation of currency or monetary instruments.

(a) Each person who physically transports, mails, or ships, or causes to be physically transported, mailed, or shipped, or attempts to physically transport, mail or ship, or attempts to cause to be physically transported, mailed or shipped, currency or other monetary instruments in an aggregate amount exceeding $10,000 at one time from the United States to any place outside the United States, or into the United States from any place outside the United States, shall make a report thereof. A person is deemed to have caused such transportation, mailing or shipping when he

aids, abets, counsels, commands, procures, or requests it to be done by a financial institution or any other person.

(b) Each person who receives in the U.S. currency or other monetary instruments in an aggregate amount exceeding $10,000 at one time which have been transported, mailed, or shipped to such person from any place outside the United States with respect to which a report has not been filed under paragraph (a) of this section, whether or not required to be filed thereunder, shall make a report thereof, stating the amount, the date of receipt, the form of monetary instruments, and the person from whom received.

(c) This section shall not require reports by:

(1) A Federal Reserve;

(2) A bank, a foreign bank, or a broker or dealer in securities, in respect to currency or other monetary instruments mailed or shipped through the postal service or by common carrier;

(3) A commercial bank or trust company organized under the laws of any State or of the United States with respect to overland shipments of currency or monetary instruments shipped to or received from an established customer maintaining a deposit relationship with the bank, in amounts which the bank may reasonably conclude do not exceed amounts commensurate with the customary conduct of the business, industry or profession of the customer concerned;

(4) A person who is not a citizen or resident of the United States in respect to currency or other monetary instruments mailed or shipped from abroad to a bank or broker or dealer in securities through the postal service or by common carrier;

(5) A common carrier of passengers in respect to currency or other monetary instruments in the possession of its passengers;

(6) A common carrier of goods in respect to shipments of currency or monetary instruments not declared to be such by the shipper;

(7) A travelers' check issuer or its agent in respect to the transportation of travelers' checks prior to their delivery to selling agents for eventual sale to the public;

(8) By a person with respect to a restrictively endorsed traveler's check that is in the collection and reconciliation process after the traveler's check has been negotiated;

(9) Nor by a person engaged as a business in the transportation of currency, monetary instruments and other commercial papers with

respect to the transportation of currency or other monetary instruments overland between established offices of banks or brokers or dealers in securities and foreign persons.

(d) A transfer of funds through normal banking procedures which does not involve the physical transportation of currency or monetary instruments is not required to be reported by this section. This section does not require that more than one report be filed covering a particular transportation, mailing or shipping of currency or other monetary instruments with respect to which a complete and truthful report has been filed by a person. However, no person required by paragraph (a) or (b) of this section to file a report shall be excused from liability for failure to do so if, in fact, a complete and truthful report has not been filed.

* * * * *

Section 103.33 Records to be made and retained by financial institutions.

Each financial institution shall retain either the original or a microfilm or other copy or reproduction of each of the following:

(a) A record of each extension of credit in an amount in excess of $10,000, except an extension of credit secured by an interest in real property, which record shall contain the name and address of the person to whom the extension of credit is made, the amount thereof, the nature or purpose thereof, and the date thereof;

(b) A record of each advice, request, or instruction received or given regarding any transaction resulting (or intended to result and later canceled if such a record is normally made) in the transfer of currency or other monetary instruments, funds, checks, investment securities, or credit, of more than $10,000 to or from any person, account, or place outside the United States.

(c) A record of each advice, request, or instruction given to another financial institution or other person located within or without the United States, regarding a transaction intended to result in the transfer of funds, or of currency, other monetary instruments, checks, investment securities, or credit, of more than $10,000 to a person, account or place outside the United States.

(d) A record of such information for such period of time as the Secretary may require in an order issued under Section 103.26(a), not to exceed five years.

(e) *Banks.* Each agent, agency, branch, or office located within the United States of a bank is subject to the requirements of this paragraph (e) with respect to a funds transfer in the amount of $3,000 or more:

(1) *Recordkeeping requirements.* (i) For each payment order that it accepts as an originator's bank, a bank shall obtain and retain either the original or a microfilm, other copy, or electronic record of the following information relating to the payment order:

(A) The name and address of the originator;

(B) The amount of the payment order;

(C) The execution date of the payment order;

(D) Any payment instructions received from the originator with the payment order;

(E) The identity of the beneficiary's bank; and

(F) As many of the following items as are received with the payment order:[2]

(1) The name and address of the beneficiary;

(2) The account number of the beneficiary; and

(3) Any other specific identifier of the beneficiary.

(ii) For each payment order that it accepts as an intermediary bank, a bank shall retain either the original or a microfilm, other copy, or electronic record of the payment order.

(iii) For each payment order that it accepts as a beneficiary's bank, a bank shall retain either the original or a microfilm, other copy, or electronic record of the payment order.

(2) *Originators other than established customers.* In the case of a payment order from an originator that is not an established customer, in addition to obtaining and retaining the information required in paragraph (e)(1)(i) of this section:

(i) If the payment order is made in person, prior to acceptance the originator's bank shall verify the identity of the person placing the payment order. If it accepts the payment order, the originator's bank shall obtain and retain a record of the name and address, the type of identifi-

[2]For funds transfers effected through the Federal Reserve's Fedwire funds transfer system, only one of the items is required to be retained, if received with the payment order, until such time as the bank that sends the order to the Federal Reserve Bank completes its conversion to the expanded Fedwire message format.

cation reviewed, the number of the identification document (*e.g.*, driver's license), as well as a record of the person's taxpayer identification number (*e.g.*, social security or employer identification number) or, if none, alien identification number or passport number and country of issuance, or a notation in the record of the lack thereof. If the originator's bank has knowledge that the person placing the payment order is not the originator, the originator's bank shall obtain and retain a record of the originator's taxpayer identification number (*e.g.*, social security or employer identification number) or, if none, alien identification number or passport number and country of issuance, if known by the person placing the order, or a notation in the record of the lack thereof.

(ii) If the payment order accepted by the originator's bank is not made in person, the originator's bank shall obtain and retain a record of name and address of the person placing the payment order, as well as the person's taxpayer identification number (*e.g.*, social security or employer identification number) or, if none, alien identification number or passport number and country of issuance, or a notation in the record of the lack thereof, and a copy or record of the method of payment (*e.g.*, check or credit card transaction) for the funds transfer. If the originator's bank has knowledge that the person placing the payment order is not the originator, the originator's bank shall obtain and retain a record of the originator's taxpayer identification number (*e.g.*, social security or employer identification number) or, if none, alien identification number or passport number and country of issuance, if known by the person placing the order, or a notation in the record of the lack thereof.

(3) *Beneficiaries other than established customers.* For each payment order that it accepts as a beneficiary's bank for a beneficiary that is not an established customer, in addition to obtaining and retaining the information required in paragraph (e)(1)(iii) of this section:

(i) if the proceeds are delivered in person to the beneficiary or its representative or agent, the beneficiary's bank shall verify the identity of the person receiving the proceeds and shall obtain and retain a record of the name and address, the type of identification reviewed, and the number of the identification document (*e.g.*, driver's license), as well as a record of the person's taxpayer identification number (*e.g.*, social security or employer identification number) or, if none, alien identification number or passport number and country of issuance, or a notation in the record of the lack thereof. If the beneficiary's bank has knowledge that the person receiving the proceeds is not the beneficiary, the beneficiary's bank shall obtain and retain a record of the beneficiary's name and address, as well as the beneficiary's taxpayer identification number (*e.g.*, social security or employer identification number) or, if none, alien iden-

tification number or passport number and country of issuance, if known by the person receiving the proceeds, or a notation in the record of the lack thereof.

(ii) if the proceeds are delivered other than in person, the beneficiary's bank shall retain a copy of the check or other instrument used to effect payment, or the information contained thereon, as well as the name and address of the person to which it was sent.

(4) *Retrievability.* The information that an originator's bank must retain under paragraphs (e)(1)(i) and (e)(2) of this section shall be retrievable by the originator's bank by reference to the name of the originator. If the originator is an established customer of the originator's bank and has an account used for funds transfers, then the information also shall be retrievable by account number. The information that a beneficiary's bank must retain under paragraphs (e)(1)(iii) and (e)(3) of this section shall be retrievable by the beneficiary's bank by reference to the name of the beneficiary. If the beneficiary is an established customer of the beneficiary's bank and has an account used for funds transfers, then the information also shall be retrievable by account number. This information need not be retained in any particular manner, so long as the bank is able to retrieve the information required by this paragraph, either by accessing funds transfer records directly or through reference to some other record maintained by the bank.

(5) *Verification.* Where verification is required under paragraphs (e)(2) and (e)(3) of this section, a bank shall verify a person's identity by examination of a document (other than a bank signature card), preferably one that contains the person's name, address, and photograph, that is normally acceptable by financial institutions as a means of identification when cashing checks for persons other than established customers. Verification of the identity of an individual who indicates that he or she is an alien or is not a resident of the United States may be made by passport, alien identification card, or other official document evidencing nationality or residence (*e.g.*, a foreign driver's license with indication of home address).

(6) *Exceptions.* The following funds transfers are not subject to the requirements of this section:

(i) Funds transfers where the originator and beneficiary are any of the following:

(A) A bank;

(B) A wholly-owned domestic subsidiary of a bank chartered in the United States;

(C) A broker or dealer in securities;

(D) A wholly-owned domestic subsidiary of a broker or dealer in securities;

(E) The United States;

(F) A state or local government; or

(G) A federal, state or local government agency or instrumentality; and

(ii) Funds transfers where both the originator and the beneficiary are the same person and the originator's bank and the beneficiary's bank are the same bank.

(f) *Nonbank financial institutions.* Each agent, agency, branch, or office located within the United States of a financial institution other than a bank is subject to the requirements of this paragraph (f) with respect to a transmittal of funds in the amount of $3,000 or more:

(1) *Recordkeeping requirements.* (i) For each transmittal order that it accepts as a transmittor's financial institution, a financial institution shall obtain and retain either the original or a microfilm, other copy, or electronic record of the following information relating to the transmittal order:

(A) The name and address of the transmittor;

(B) The amount of the transmittal order;

(C) The execution date of the transmittal order;

(D) Any payment instructions received from the transmittor with the transmittal order;

(E) The identity of the recipient's financial institution;

(F) As many of the following items as are received with the transmittal order:[3]

(1) The name and address of the recipient;

(2) The account number of the recipient; and

[3]For transmittals of funds effected through the Federal Reserve's Fedwire funds transfer system by a domestic broker or dealers in securities, only one of the items is required to be retained, if received with the transmittal order, until such time as the bank that sends the order to the Federal Reserve Bank completes its conversion to the expanded Fedwire message format.

(3) Any other specific identifier of the recipient; and

(G) Any form relating to the transmittal of funds that is completed or signed by the person placing the transmittal order.

(ii) For each transmittal order that it accepts as an intermediary financial institution, a financial institution shall retain either the original or a microfilm, other copy, or electronic record of the transmittal order.

(iii) For each transmittal order that it accepts as a recipient's financial institution, a financial institution shall retain either the original or a microfilm, other copy, or electronic record of the transmittal order.

(2) *Transmittors other than established customers.* In the case of a transmittal order from a transmittor that is not an established customer, in addition to obtaining and retaining the information required in paragraph (f)(1)(i) of this section:

(i) If the transmittal order is made in person, prior to acceptance the transmittor's financial institution shall verify the identity of the person placing the transmittal order. If it accepts the transmittal order, the transmittor's financial institution shall obtain and retain a record of the name and address, the type of identification reviewed, and the number of the identification document (*e.g.*, driver's license), as well as a record of the person's taxpayer identification number (*e.g.*, social security or employer identification number) or, if none, alien identification number or passport number and country of issuance, or a notation in the record of the lack thereof. If the transmittor's financial institution has knowledge that the person placing the transmittal order is not the transmittor, the transmittor's financial institution shall obtain and retain a record of the transmittor's taxpayer identification number (*e.g.*, social security or employer identification number) or, if none, alien identification number or passport number and country of issuance, if known by the person placing the order, or a notation in the record of the lack thereof.

(ii) If the transmittal order accepted by the transmittor's financial institution is not made in person, the transmittor's financial institution shall obtain and retain a record of the name and address of the person placing the transmittal order, as well as the person's taxpayer identification number (*e.g.*, social security or employer identification number) or, if none, alien identification number or passport number and country of issuance, or a notation in the record of the lack thereof, and a copy or record of the method of payment (*e.g.*, check or credit card transaction) for the transmittal of funds. If the transmittor's financial institution has knowledge that the person placing the transmittal order is not the transmittor, the transmittor's financial institution shall obtain and retain a record of the transmittor's taxpayer identification number (*e.g.*, social

security or employer identification number) or, if none, alien identification number or passport number and country of issuance, if known by the person placing the order, or a notation in the record the lack thereof.

(3) *Recipients other than established customers.* For each transmittal order that it accepts as a recipient's financial institution for a recipient that is not an established customer, in addition to obtaining and retaining the information required in paragraph (f)(1)(iii) of this section:

(i) If the proceeds are delivered in person to the recipient or its representative or agent, the recipient's financial institution shall verify the identity of the person receiving the proceeds and shall obtain and retain a record of the name and address, the type of identification reviewed, and the number of the identification document (*e.g.*, driver's license), as well as a record of the person's taxpayer identification number (*e.g.*, social security or employer identification number) or, if none, alien identification number or passport number and country of issuance, or a notation in the record of the lack thereof. If the recipient's financial institution has knowledge that the person receiving the proceeds is not the recipient, the recipient's financial institution shall obtain and retain a record of the recipient's name and address, as well as the recipient's taxpayer identification number (*e.g.*, social security or employer identification number) or, if none, alien identification number or passport number and country of issuance, if known by the person receiving the proceeds, or a notation in the record of the lack thereof.

(ii) If the proceeds are delivered other than in person, the recipient's financial institution shall retain a copy of the check or other instrument used to effect payment, or the information contained thereon, as well as the name and address of the person to which it was sent.

(4) *Retrievability.* The information that a transmittor's financial institution must retain under paragraphs (f)(1)(i) and (f)(2) of this section shall be retrievable by the transmittor's financial institution by reference to the name of the transmittor. If the transmittor is an established customer of the transmittor's financial institution and has an account used for transmittals of funds, then the information also shall be retrievable by account number. The information that a recipient's financial institution must retain under paragraphs (f)(1)(iii) and (f)(3) of this section shall be retrievable by the recipient's financial institution by reference to the name of the recipient. If the recipient is an established customer of the recipient's financial institution and has an account used for transmittals of funds, then the information also shall be retrievable by account number. This information need not be retained in any particular manner, so long as the financial institution is able to retrieve the information required by this paragraph, either by accessing transmittal of funds

records directly or through reference to some other record maintained by the financial institution.

(5) *Verification.* Where verification is required under paragraphs (f)(2) and (f)(3) of this section, a financial institution shall verify a person's identity by examination of a document (other than a customer signature card), preferably one that contains the person's name, address, and photograph, that is normally acceptable by financial institutions as a means of identification when cashing checks for persons other than established customers. Verification of the identity of an individual who indicates that he or she is an alien or is not a resident of the United States may be made by passport, alien identification card, or other official document evidencing nationality or residence (*e.g.*, a foreign driver's license with indication of home address).

(6) *Exceptions.* The following transmittals of funds are not subject to the requirements of this section:

(i) Transmittals of funds where the transmittor and the recipient are any of the following:

(A) A bank;

(B) A wholly-owned domestic subsidiary of a bank chartered in the United States;

(C) A broker or dealer in securities;

(D) A wholly-owned domestic subsidiary of a broker or dealer in securities;

(E) The United States;

(F) A state or local government; or

(G) A federal, state or local government agency or instrumentality; and

(ii) Transmittals of funds where both the transmittor and the recipient are the same person and the transmittor's financial institution and the recipient's financial institution are the same broker or dealer in securities.

(g) Any transmittor's financial institution or intermediary financial institution located within the United States shall include in any transmittal order for a transmittal of funds in the amount of $3,000 or more, information as required in this paragraph (g):

(1) A transmittor's financial institution shall include in a transmittal order, at the time it is sent to a receiving financial institution, the following information:

(i) The name and, if the payment is ordered from an account, the account number of the transmittor;

(ii) The address of the transmittor, except for a transmittal order through Fedwire until such time as the bank that sends the order to the Federal Reserve Bank completes its conversion to the expanded Fedwire format;

(iii) The amount of the transmittal order;

(iv) The execution date of the transmittal order;

(v) The identity of the recipient's financial institution;

(vi) As many of the following items as are received with the transmittal order:[4]

(A) The name and address of the recipient;

(B) The account number of the recipient;

(C) Any other specific identifier of the recipient; and

(vii) Either the name and address or numerical identifier of the transmittor's financial institution.

(2) A receiving financial institution that acts as an intermediary financial institution, if it accepts a transmittal order, shall include in a corresponding transmittal order at the time it is sent to the next receiving financial institution, the following information, if received from the sender:

(i) The name and the account number of the transmittor;

(ii) The address of the transmittor, except for a transmittal order through Fedwire until such time as the bank that sends the order to the Federal Reserve Bank completes its conversion to the expanded Fedwire format;

(iii) The amount of the transmittal order;

(iv) The execution date of the transmittal order;

(v) The identity of the recipient's financial institution;

[4]For transmittals of funds effected through the Federal Reserve's Fedwire funds transfer system by a financial institution, only one of the items is required to be included in the transmittal order, if received with the sender's transmittal order, until such time as the bank that sends the order to the Federal Reserve Bank completes its conversion to the expanded Fedwire message format.

(vi) As many of the following items as are received with the transmittal order:[5]

(A) The name and address of the recipient;

(B) The account number of the recipient;

(C) Any other specific identifier of the recipient; and

(vii) Either the name and address or numerical identifier of the transmittor's financial institution.

(3) *Safe harbor for transmittals of funds prior to conversion to the expanded Fedwire message format.* The following provisions apply to transmittals of funds effected through the Federal Reserve's Fedwire funds transfer system or otherwise by a financial institution before the bank that sends the order to the Federal Reserve Bank or otherwise completes its conversion to the expanded Fedwire message format.

(i) *Transmittor's financial institution.* A transmittor's financial institution will be deemed to be in compliance with the provisions of paragraph (g)(1) of this section if it:

(A) Includes in the transmittal order, at the time it is sent to the receiving financial institution, the information specified in paragraphs (g)(1)(iii) through (v), and the information specified in paragraph (g)(1)(vi) of this section to the extent that such information has been received by the financial institution, and

(B) Provides the information specified in paragraphs (g)(1)(i), (ii) and (vii) of this section to a financial institution that acted as an intermediary financial institution or recipient's financial institution in connection with the transmittal order, within a reasonable time after any such financial institution makes a request therefor in connection with the requesting financial institution's receipt of a lawful request for such information from a federal, state, or local law enforcement or financial regulatory agency, or in connection with the requesting financial institution's own Bank Secrecy Act compliance program.

[5]For transmittals of funds effected through the Federal Reserve's Fedwire funds transfer system by a financial institution, only one of the items is required to be included in the transmittal order, if received with the sender's transmittal order, until such time as the bank that sends the order to the Federal Reserve Bank completes its conversion to the expanded Fedwire message format.

(ii) *Intermediary financial institution.* An intermediary financial institution will be deemed to be in compliance with the provisions of paragraph (g)(2) of this section if it:

(A) Includes in the transmittal order, at the time it is sent to the receiving financial institution, the information specified in paragraphs (g)(2)(iii) through (g)(2)(vi) of this section, to the extent that such information has been received by the intermediary financial institution; and

(B) Provides the information specified in paragraphs (g)(2)(i), (ii) and (vii) of this section, to the extent that such information has been received by the intermediary financial institution, to a financial institution that acted as an intermediary financial institution or recipient's financial institution in connection with the transmittal order, within a reasonable time after any such financial institution makes a request therefor in connection with the requesting financial institution's receipt of a lawful request for such information from a federal, state, or local law enforcement or regulatory agency, or in connection with the requesting financial institution's own Bank Secrecy Act compliance program.

(iii) *Obligation of requesting financial institution.* Any information requested under paragraph (g)(3)(i)(B) or (g)(3)(ii)(B) of this section shall be treated by the requesting institution, once received, as if it had been included in the transmittal order to which such information relates.

(4) *Exceptions.* The requirements of this paragraph (g) shall not apply to transmittals of funds that are listed in paragraph (e)(6) or (f)(6) of this section.

* * * * *

Section 103.43 Availability of information.

(a) The Secretary may within his discretion disclose information reported under this part for any reason consistent with the purposes of the Bank Secrecy Act, including those set forth in paragraphs (b) through (d) of this section.

(b) The Secretary may make any information set forth in any report received pursuant to this part available to another agency of the United States, to an agency of a state or local government or to an agency of a

foreign government, upon the request of the head of such department or agency made in writing and stating the particular information desired, the criminal, tax or regulatory purpose for which the information is sought, and the official need for the information.

(c) The Secretary may make any information set forth in any report received pursuant to this part available to the Congress, or any committee or subcommittee thereof, upon a written request stating the particular information desired, the criminal, tax or regulatory purpose for which the information is sought, and the official need for the information.

(d) The Secretary may make any information set forth in any report received pursuant to this part available to any other department or agency of the United States that is a member of the Intelligence Community, as defined by Executive Order 12333 or any succeeding executive order, upon the request of the head of such department or agency made in writing and stating the particular information desired, the national security matter with which the information is sought and the official need therefor.

(e) Any information made available under this section to other department or agencies of the United States, any state or local government, or any foreign government shall be received by them in confidence, and shall not be disclosed to any person except for official purposes relating to the investigation, proceeding or matter in connection with which the information is sought.

(f) The Secretary may require that a state or local government department or agency requesting information under paragraph (b) of this section pay fees to reimburse the Department of the Treasury for costs incidental to such disclosure. The amount of such fees will be set in accordance with the statute on fees for government services, 31 U.S.C. 9701.

Notes

Introduction (Effros)

1. Maastricht Treaty, Article 105.2.

2. This paper is based in part on the introduction prepared by the author for *Payment Systems of the World,* R. Effros (ed.) (Oceana: 1994).

3. Chief among these are the Conventions providing for (i) Uniform Law on Bills of Exchange and Promissory Notes, and (ii) Uniform Law for Cheques set forth with annexes and protocol in League of Nations Treaty Series, Vol. 143 (1933–34). These Conventions are hereinafter called the Geneva Conventions.

4. E.P. Ellinger, *The Giro System and Electronic Transfers of Funds,* Lloyd's Mar. & Com. L.Q. 178 (May 1986). For the most part, these systems have in the past involved the physical movement of paper.

5. *See* Robert C. Effros, *A Banker's Primer on the Law of Electronic Funds Transfers,* 105 Banking Law Journal 510 (1988) published by Warren Gorham & Lamont, from which certain portions of the following material are drawn.

6. *See generally,* Sue Ganske Graziano and Selma Fatma Baharoglu, *Automated Teller Machines: Boon or Bane,* 91 Com. L.J. 451 (1986).

7. 15 U.S.C. § 1601 *et seq.* (1996).

8. 12 C.F.R. part 226 (1997).

9. 15 U.S.C. § 1643 (a)(1) (1996); 12 C.F.R. § 226.12 (b) (1997).

10. 12 C.F.R. § 226.12 (c)(3)(i) (1997).

11. 12 C.F.R. § 226.13 (1997).

12. 15 U.S.C. § 1642 (1996); 12 C.F.R. § 226.12(a) (1997).

13. 12 C.F.R. § 226.5(b) (1997).

14. 15 U.S.C. §§ 1693–1693r (1996). The implementing regulation is Regulation E, 12 C.F.R. § 205.1 (1997).

15. 15 U.S.C. § 1693i(a) (1996); 12 C.F.R. § 205.5(b) (1997).

16. 15 U.S.C. § 1693c(a); 12 C.F.R. § 205.7(b) (1997).

17. 15 U.S.C. § 1693d(a) (1996); 12 C.F.R. § 205.9 (1997).

18. 15 U.S.C. § 1693d(c) (1996).

19. 12 C.F.R. § 205.10(c) (1997).

20. 15 U.S.C. § 1693(f) (1996); 12 C.F.R. § 205.11 (1997).

21. *See* 15 U.S.C. § 1693a(6)(b) (1996); 12 C.F.R. § 205.3(b) (1997).

22. Commission Recommendation of 8 December 1987 on a European Code relating to Electronic Payment (87/598/EEC), O.J. No. L365/72, 24 December 1987.

23. Commission Recommendation of 17 November 1988 concerning payment systems and in particular the relationship between cardholder and card issuer (88/590/EEC), O.J. No. L317/55, 24 November 1988.

24. *See generally,* R. Cranston, 66 Australian Law Journal 225 (April 1992).

25. Commission Recommendation of 30 July 1997 concerning transactions by electronic payment instruments and in particular the relationship between issuer and holder (97/489/EC), O.J. No. L208 2/8/1997 P. 0052.

26. It should be noted that electronic cash can also be stored on individual personal computers.

27. Report to the Congress on the Application of the Electronic Fund Transfer Act to Electronic Stored-Value Products (March 1997).

28. *See generally,* Walter A. Effross, *Putting the Cards Before the Purse?: Distinctions, Differences and Dilemmas in the Regulation of Stored Value Card Systems,* 65 University of Missouri-Kansas City Law Review 319 (Spring 1997).

29. General Counsel's Opinion No. 8; *Stored Value Cards and Other Electronic Payment Systems,* 61 Fed. Reg. 40,490 (August 2, 1996).

30. Office of the Comptroller of the Currency [OCC] *Bulletin 96-48, Stored Value Systems: Information for Bankers and Examiners* (September 1996).

31. *A Commercial Lawyer's Take on the Electronic Purse; An Analysis of Commercial Law Issues Associated with Stored-Value Cards and Electronic Money,* a report of the Task Force on Stored-Value Cards, 52 Business Lawyer 653 (1997).

32. 12 C.F.R. § 210.25 (1997). Operating circulars of the Federal Reserve banks are also relevant.

33. *See* 12 C.F.R. § 210.25(b)(1) (1997).

34. *See generally,* Carl Felsenfeld, *The Compatibility of the UNCITRAL Model Law on International Credit Transfers with Article 4A of the UCC,* 60 Fordham Law Review, S53 (1992).

35. In practice, the beneficiary bank's liability to its beneficiary is governed by the Federal Reserve Regulation CC, which sets a time when funds must be made available (12 C.F.R. Subsection 229.10–12). UCC Article 4 A also provides for the recovery of consequential damages from a receiving bank to the extent that they are expressly provided for in a written agreement (Section 4A-305(c) and (d)). According to the UNCITRAL Model Law, consequential damages may arise under local law if a bank has improperly executed a payment order or failed to execute it either with the specific intent to cause losses or recklessly with the actual knowledge that losses are likely to result (Article 18).

36. However, it would apparently require only minor amendments to Article I to permit the UNCITRAL Model Law to govern national transfers.

37. Commission Recommendation of 14 February 1990 on the transparency of banking conditions relating to cross-border financial transactions (90/109/EEC), O.J. No. L067, 15 March 1990 P. 0039.

38. Amended Proposal for a European Parliament and Council Directive on EU credit transfers, O.J. No. C360, 17 December 1994 P. 0013.

39. Directive of the European Parliament and of the Council of 27 January 1997 on cross-border credit transfers (97/5/EC), O.J. No. L042.

40. *Id.* Art. 1.

41. *Id.* Art. 3.

42. *Id.* Art. 4.

43. *Id.* Art. 6, paragraph 1.

44. *Id.* Art. 6, paragraph 2.

45. *Id.*

46. UNCITRAL Model Law On International Credit Transfers, November 25, 1992, 23 UNCITRAL Yearbook 413 (1992), Art. 19(2). The UNCITRAL Model Law is reprinted in 2 *Current Legal Issues Affecting Central Banks* 312 (Robert C. Effros ed., 1994).

47. *Id.* Art. 14.

48. *Id.* Art. 16.

49. *Id.* Art. 12(5).

50. *Commission Recommendation, supra* note 37, Art. 8, paragraph 1.

51. *Id.*

52. *Id.* Art. 6, paragraph 1.

53. *Id.* Art. 6, paragraph 2.

54. UNCITRAL Model Law, *supra* note 45, Art. 12.

55. Federal Deposit Insurance Corporation Improvement Act of 1991, Title IV, Subtitle A, Public Law No. 102-242, 105 Stat. 2236 (1991).

56. *See, e.g.*, U.C.C. §§ 1–102(3) and 3-310(b).

57. *See, e.g.*, U.C.C. § 4A-501(a).

58. Consolidated Payment Cards Act, etc. (Consolidated Act No. 811 of September 12th, 1994).

59. *See* J. Mitchell, *Electronic Banking and the Consumer, the European Dimension,* pp. 16–17, Policy Studies Institute (1988).

60. Arthur Lenhoff, *Contracts of Adhesion and Freedom of Contract,* 36 Tul. L. R. 481 (1962), cited in Andrew Burgess, *Consumer Adhesion Contracts and Unfair Terms: A Critique of Current Theory and a Suggestion,* 15 Anglo-American Law Review at p. 257 (1986).

61. See generally, Andrew Burgess, Consumer Adhesion Contracts and Unfair Terms: A Critique of Current Theory and a Suggestion, 15 Anglo-American Law Review 255 (1986).

Chapter **1A**, "Special Drawing Rights" (Gianviti)

1. *See* International Monetary Fund, Articles of Agreement (1993).

2. International Monetary Fund, *By-Laws, Rules and Regulations,* Rule O–1 at 48 (51st issue, 1996).

3. Articles of Agreement, *supra* note 1, Art. VIII, § 7 and Art. XXII.

4. *See* International Monetary Fund, *Report of the Executive Board to the Board of Governors on the Proposed Fourth Amendment of the Articles of Agreement of the International Monetary Fund* (agreed to on September 19, 1997), *reprinted herein as* Appendix I(1) ; *see also IMF Executive Board Agrees SDR Allocation Proposal,* Press Release No. 97/43 (September 20, 1997).

5. Articles of Agreement, *supra* note 1, Art. XXVIII; *see* International Monetary Fund, *IMF Board of Governors Approves SDR Amendment,* Press Release No. 97/45 (September 23, 1997).

Chapter **1B**, "On Being a Lawyer in the International Monetary Fund" (Holder)

1. International Monetary Fund, Articles of Agreement (April 1993).

2. *Id.* Art. II, § 2.

3. Agreement Between the United Nations and the International Monetary Fund, November 15, 1947, *reprinted in Selected Decisions and Selected Documents of the International Monetary Fund* 641 (22nd issue, 1997).

4. Articles of Agreement, *supra* note 1, Art. VIII, §§ 2 and 3.

5. *Id.* Art. XIV, §§ 1 and 2.

6. *Id.* Art. XV, § 1.

7. On September 23, 1997, the Board of Governors of the Fund adopted a resolution approving a proposal of the Executive Board for amending the Fund's Articles to allow for a special one-time allocation of SDRs so as to equalize members' ratios of cumulative allocations to their Ninth Review quotas at approximately 29.32 percent. *See* International Monetary Fund, *Report of the Executive Board to the Board of Governors on the Proposed Fourth Amendment of the Articles of Agreement of the International Monetary Fund* (agreed to on September 19, 1997), *reprinted herein as* Appendix I(1); *see also* International Monetary Fund, *IMF Executive Board Agrees SDR Allocation Proposal,* Press Release No. 97/43 (September 20, 1997). In order to enter into force, the amendment will require acceptance by three-fifths of the members of the Fund, having 85 percent of the total voting power. *See* Articles of Agreement, *supra* note 1, Art. XXVIII; International Monetary Fund, *IMF Board of Governors Approves SDR Amendment,* Press Release No. 97/45 (September 23, 1997).

8. *See* Articles of Agreement, *supra* note 1, Art. V, § 2(b).

9. *Id.* Art. XIV, § 1.

10. *Id.* Art. IX.

11. United Nations Convention on the Privileges and Immunities of the Specialized Agencies, November 21, 1947, *reprinted in Selected Decisions and Selected Documents of the International Monetary Fund, supra* note 3, at 606.

12. *See Selected Decisions and Selected Documents of the International Monetary Fund, supra* note 3, at 510 *et seq.*; International Monetary Fund, *By-Laws, Rules and Regulations* 1–18 (51st issue, 1996) (setting forth the By-Laws).

13. *See Selected Decisions and Selected Documents of the International Monetary Fund, supra* note 3, at 1 *et seq.*; *By-Laws, Rules and Regulations, supra* note 11, at 19 *et seq.* (setting forth the Rules and Regulations).

14. *See supra* note 10.

15. Vienna Convention on the Law of Treaties, done in Vienna on May 23, 1969 and entered into force on January 27, 1980, 1155 United Nations Treaty Series 331.

16. Agreement Between the United Nations and the International Monetary Fund, *supra* note 3, Art. VIII.

Chapter 2, "The World Bank in the Nineties" (Shihata)

1. This paper updates the author's Introduction of his book, Ibrahim F.I. Shihata, *The World Bank in a Changing World* (vol. 2, 1995).

2. The World Bank Group of institutions consists of the International Bank for Reconstruction and Development (IBRD), the International Finance Corporation (IFC), the International Development Association (IDA), the International Centre for Settlement of Investment Disputes (ICSID), and the Multilateral Investment Guarantee Agency (MIGA). In this chapter, the term World Bank or Bank covers both the IBRD and IDA, unless the context indicates that it covers the IBRD only.

3. The World Bank, *Global Economic Prospects and the Developing Countries* (1995) (quoted material appears on the back cover).

4. Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, April 15, 1994, *reprinted in The Results of the Uruguay Round of Multilateral Trade Negotiations* (1994).

5. Marrakesh Agreement Establishing the World Trade Organization, *in* Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, *supra* note 4.

6. The World Bank, 1 *World Debt Tables 1996* at 7 (Table 1.1).

7. *Id.*

8. *Id.*

9. *Id.* Developing countries are defined by the Bank for the purpose of the above statistics to include all low- and middle-income economies with a 1994 per capita gross national product of less than $8,956, a definition that applied to 150 countries. *Id.* at 52.

10. The World Bank, *Annual Financial Report FY1995*, SecM95-871, at 4, 6.

11. *Id.; see also* The World Bank, *Annual Report 1995* at 36.

12. *See* The World Bank, 1 *Annual Report on Portfolio Performance-FY1995*, R95-207, paragraph 1.10 (1995). Bank portfolio is defined in this context to include "(i) all loans with revised closing dates after July 1, 1994 and a positive undisbursed balance at the beginning of the fiscal year, and (ii) all loans approved during FY1995." *Id.* Statistical Appendix.

13. *See* International Bank for Reconstruction and Development, Articles of Agreement, Art. I (as amended effective Feb. 16, 1989).

14. *Id.* Art. III, § 4(ii).

15. *Id.* Art. III, § 4(i).

16. For the circumstances surrounding the creation of MIGA, *see generally* Ibrahim F.I. Shihata, *Multilateral Investment Guarantee Agency and Foreign Investment* (1988).

17. The World Bank, *World Development Report 1991* at iii and 1–2.

18. The World Bank, *Advancing Social Development* at x (1995) [hereinafter *Advancing Social Development*].

19. 1 *World Debt Tables, supra* note 6, at 17 (Table 1.4).

20. Articles of Agreement, *supra* note 13, Art. I.

21. *Advancing Social Development, supra* note 18, at xi; *Annual Report 1995, supra* note 11, at 18.

22. *Advancing Social Development, supra* note 18, at xi.

23. *Annual Report 1995, supra* note 11, at 18.

24. *See id.*

25. *Advancing Social Development, supra* note 18, at xii.

26. For details *see* Shihata, *supra* note 1, chapter 6 ("The World Bank and Non-Governmental Organizations"); *see also Advancing Social Development*, *supra* note 18.

27. Lawrence H. Summers, Speech at the Overseas Development Council's Annual Meeting (October 11, 1994).

28. For a more detailed explanation, *see* Ibrahim F.I. Shihata, 1 *The World Bank in a Changing World* 53–96 ("The World Bank and 'Governance' Issues in Its Borrowing Members") (1991).

29. The World Bank, *Sub-Saharan Africa: From Crisis to Sustainable Growth: A Long-Term Perspective Study* (1989).

30. Memorandum regarding Issues of "Governance" in Borrowing Members: The Extent of their Relevance under the Bank's Articles of Agreement, SecM91-31 (February 5, 1991).

31. For details, *see* Shihata, *supra* note 1, at 553–578; Shihata, *supra* note 28, at 97–134.

32. *See* Shihata, *supra* note 1, at chapters 1, 5, and 17; Shihata, *supra* note 28, chapter 4.

33. *See* Andrés Rigo, *Developments at the International Bank for Reconstruction and Development: The Restructuring of the Global Environment Facility, in* 4 *Current Legal Issues Affecting Central Banks* 29 (Robert C. Effros ed., 1997).

34. John A. Dixon and Andrew Steer, *The World Bank and the Environment: A Fourfold Agenda, in Making Development Sustainable: From Concepts to Action* 25, 27 (Ismail Sergeldin and Andrew Steer eds., 1994); Shihata, *supra* note 1, chapter 5.

35. 1 *World Debt Tables 1996*, *supra* note 6, at 30 and 55. Developing countries' debt stood at $1.5 trillion in 1990. *Id.* at 31 (Table 2.3). This debt stood at $639 billion in 1980 and $69 billion in 1970. The World Bank, 1 *World Debt Tables 1990–91* at 12 (Table 1) (1990); International Bank for Reconstruction and Development, *World Debt Tables*, Report No. EC–167-72, at 1 (Table 1) (1973). However, the definition of these countries has also changed.

36. *See* 1 *World Debt Tables 1996, supra* note 6, at 33 (Box 2.2).

37. The International Monetary Fund and the World Bank, *Multilateral Debt of the Heavily Indebted Poor Countries* 5 (Chart 1) (1995).

38. *Id.* at 7. "Heavily indebted poor countries" include 41 countries, of which 32 are defined as "severely indebted low-income countries." *Id.* at 1 and 4 (Table 1).

39. For example, the United Kingdom presented a proposal for a clear exit strategy for the poorest countries with regard to multilateral debt through more concessional resources or greater concessionality, during the 1994 meeting of the Commonwealth Finance Ministers and the Fall 1994 meeting of the Development Committee.

40. *See, e.g.*, The Commission on Global Governance, *Our Global Neighbourhood: The Report of the Commission on Global Governance* 201–203, 343 (1995).

41. *See* The World Bank, *Learning from the Past, Embracing the Future* (1994), *reprinted in* Shihata, *supra* note 1, Appendix I at 607.

42. *See Bank Procedure (BP) 17.50: Disclosure of Operational Information* (1993), *reprinted in* Shihata, *supra* note 1, Appendix IV(B) at 721.

43. For details of this initiative, *see* Ibrahim F.I. Shihata, *The World Bank Inspection Panel* (1994). The resolution establishing the panel is reprinted as Appendix III(A) of Shihata, *supra* note 1, at 647.

44. *See* Portfolio Management Task Force, The World Bank, *Effective Implementation: Key to Development Impact*, R92–195 (November 3, 1992) [hereinafter Wapenhans Report].

45. *See* Operations Policy Department, The World Bank, *Portfolio Management: Next Steps, A Program of Action* (July 22, 1993), *summarized in* The World Bank, *Getting Results: The World Bank's Agenda for Improving Development Effectiveness* (1993).

46. Other important recommendations of the Wapenhans Report, *supra* note 44, which have since been implemented, include introducing the concept of "country portfolio performance management," allowing for country portfolio restructuring (including the reallocation of undisbursed loan balances), improving the quality of projects entering the portfolio, enhancing supervision during implementation and evaluation after project completion, making the country portfolio the unit of managerial accountability, strengthening the financial accountability system, and ensuring continuous emphasis on portfolio performance management through various measures. *See id.*

47. *See* Development Committee, Task Force on Multilateral Development Banks, *Serving a Changing World* (March 15, 1996).

48. This is Abdlatif Al-Hamad, Director-General and Chairman of the Arab Fund for Economic and Social Development. Mr. Al-Hamad was previously Minister of Finance of Kuwait and in his capacity as Bank Governor chaired the Bank's Board of Governors in 1982/83. For over 20 years, he was Director-General of the Kuwait Fund for Arab Economic Development and IDA Deputy for Kuwait.

49. *Serving a Changing World, supra* note 47, at xii.

50. *Id.* at x.

51. *Report of the Ad Hoc Committee on Board Procedures*, R92–103, approved on June 23, 1992. Mr. Naim was the Executive Director who chaired the Committee.

52. *Report of the Ad Hoc Committee on Review of Board Committees*, R94–66, IDA/R94–66, and IFC/R94-74, approved on May 31, 1994. Mrs. Maelhum was the Executive Director who chaired the Committee.

53. Net resource flows (long-term) to developing countries totaled an estimated $231.3 billion in 1995 ($64.2 billion in official development finance and $167.1 billion in private flows). *See* 1 *World Debt Tables 1996*, *supra* note 6, at 3 (Table 1). Total net disbursements of the World Bank totaled $6.102 billion in fiscal year 1995 (consisting of $897 million for the IBRD and $5.205 billion for IDA). *Annual Report 1995*, *supra* note 11, at 12. The decline in the IBRD's net disbursements is due in large part to the borrowers' repayments of large amounts of quick-disbursing loans and to prepayment of loans made in earlier years. The total gross disbursement of the IBRD in fiscal year 1995 totaled $12.672 billion. *Id.* at 12 and 37.

54. *See Learning from the Past, Embracing the Future*, *supra* note 41, Appendix I at 607, 609–610.

55. Notably, the draft agreement establishing the Middle East Bank for Economic Cooperation and Development, circulated by the U.S. government on February 24, 1995, wisely combines the varied activities carried out by the IBRD, the IFC, and MIGA in the authorized operations under its provisions.

56. *See, e.g.*, George P. Shultz, *Economics in Action: Ideas, Institutions, Policies*, 85 American Economic Review 1 (1995). In this lecture, Mr. Shultz suggested that "The overlapping activities of the Bank and Fund, the change in the traditional mission of the IMF, and the need to use scarce resources carefully all argue for a merger of these two organizations." *Id.* at 5. A more realistic approach may require elimination of "overlapping activities" and ensure that each of these two organizations strictly observes the purposes for which it was created as these are stipulated in their respective Articles of Agreement.

57. *See supra* note 4.
58. See International Monetary Fund, *IMF Executive Board Approves the Special Data Dissemination Standard,* Press Release No. 96/18 (April 16, 1996).
59. Bretton Woods Commission, *Bretton Woods: Looking to the Future* A-8 (1994).

Chapter **3,** "Developments at the International Finance Corporation" (Aizawa)

1. The author gratefully acknowledges guidance provided by Ms. Jennifer Sullivan, Deputy General Counsel of the International Finance Corporation (IFC).
2. The World Bank Group consists of the International Bank for Reconstruction and Development (known as the World Bank), established in 1945; the International Development Association (since 1960); the Multilateral Investment Guarantee Agency (since 1988); and the IFC (since 1956).
3. International Finance Corporation, *Annual Report 1995* at 3.
4. *Id.* at 6.
5. *Id.*
6. *Id.* at 9.
7. *Id.* at 7.
8. *Id.* at 12, 67–69.
9. *Id.* at 12.
10. *Id.* at 58.
11. *Id.* at 13, 99.
12. *Id.* at 14.
13. *Id.* at 8.
14. *Id.*
15. *Id.* at 38, 42.
16. *Id.* at 36, 42.
17. *Id.* at 86.
18. *Id.* at 7.
19. *Id.* at 80.
20. *Id.* at 24, 30.
21. *Id.* at 9.
22. *Id.* at 11.
23. *Id.*
24. *Id.* at 25–26.
25. *Id.* at 27.
26. *Id.*
27. *Id.* at 39.
28. *Id.* at 84.
29. *Id.* at 83.
30. The Internet address for the operational documents available in the World Bank InfoShop is: www.worldbank.org/html/pic/PIC.html.
31. *Annual Report 1995, supra* note 3, at 85.
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.* at 86–87.
36. *Id.* at 87.
37. *Id.* at 86.
38. *See* Andrés Rigo, *Developments at the International Bank for Reconstruction and Development: The Restructuring of the Global Environment Facility, in* 4 *Current Legal Issues Affecting Central Banks* 29 (Robert C. Effros ed., 1997).
39. *Annual Report 1995, supra* note 3, at 86.

Chapter 4, "Foreign Exchange Settlement Risk" (Tibbals Davy and Poulos)

1. This paper was presented by Elizabeth Tibbals Davy; only her biography appears in the biographical sketches.

2. Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries, Bank for International Settlements, *Settlement Risk in Foreign Exchange Transactions* (March 1996) [hereinafter the *Report*]. The *Report's* executive summary is reprinted herein as Appendix II (5).

The Group of Ten comprises Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

3. Group of Experts on Payment Systems of the Central Banks of the Group of Ten Countries, Bank for International Settlements, *Report on Netting Schemes* (1989).

4. Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries, Bank for International Settlements, *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* (November 1990) [hereinafter *Lamfalussy Report*]. The Lamfalussy standards, as the minimum standards are commonly known, are reprinted in 4 *Current Legal Issues Affecting Central Banks* 797 (Robert C. Effros ed., 1997).

5. *Id.*

6. Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries, Bank for International Settlements, *Central Bank Payment and Settlement Services with Respect to Cross-Border and Multi-Currency Transactions* (1993) [hereinafter *Noël Report*].

7. *Report, supra* note 2, at 33.

8. *Id.*

9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.* at 34.

13. *Id.* at 35.

14. *See id.* at 11.

15. *Id.*

16. *See id.*

17. *Id.* at 11–12.

18. *Id.* at 12.

19. *Id.*

20. *Id.*

21. *Id.* at 12–13.

22. *Id.* at 13.

23. *Id.*

24. *Id.* at 14.

25. *Id.*

26. *Id.*

27. *See id.* at 2, 18.

28. *Id.* at 18–20.

29. *Id.* at 20 (footnote omitted).

30. *See id.* at 21.

31. *See id.*

32. The New York Foreign Exchange Committee, *Reducing Foreign Exchange Settlement Risk* (October 1994), *reprinted in part as* Appendix II (6).

33. *Id.* at 23–32.

34. *Report, supra* note 2, at 21.

35. *Id.*
36. *Id.*
37. *Id.* at 22.
38. *Id.* (quoting the *Noël Report*, *supra* note 6).
39. *Id.* .
40. *Id.* at 27.
41. *See id.* at 15, note 9 (stating "FXNET is a limited partnership owned by the UK subsidiaries of 12 major banks. It is a decentralised system in which participants use common software provided by Quotron Foreign Exchange.").
42. *See id.*
43. The Foreign Exchange Committee and The British Bankers' Association, *International Foreign Exchange Master Agreement (IFEMA)* (November 1993), *reprinted in* 4 *Current Legal Issues Affecting Central Banks, supra* note 4, at 683.
44. The *Report* defines "obligation netting" as "the legally binding netting of amounts due in the same currency for settlement on the same day under two or more trades." *Report, supra* note 2, at 64.
45. *Id.* at 16 (endnote added).
46. The Multinet International Bank did not become operational in 1996; however, it began operations in 1997.
47. *Report, supra* note 2, at 16 (endnote added).
48. *Id.* at 16, note 13.
49. *Id.* at 16–17.
50. *Id.* at 17.
51. *Id.* at 28.
52. *See id.*
53. *Id.* at 29.
54. *Id.*
55. *Id.* at 29–30.
56. *Id.* at 31.
57. *Id.*
58. *See id.* at 8–9.
59. UNCITRAL Model Law on International Credit Transfers, November 25, 1992, 23 UNCITRAL Yearbook 413 (1992), *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 312 (Robert C. Effros ed., 1994).
60. Uniform Commercial Code [U.C.C.] Article 4A ("Funds Transfers") (1989), *reprinted in* 1 *Current Legal Issues Affecting Central Banks* 515 (Robert C. Effros ed., 1992).

It should be noted however that the EC Directive on Cross-Border Credit Transfers is to be implemented by all EU member states by August 14, 1999. Council Directive 97/5 of 27 January 1997 on Cross-Border Credit Transfers, 1997 Official Journal of the European Communities [O.J.] (L 43) 25, *reprinted herein as* Appendix IV (1).

61. U.C.C. § 4A–507; UNCITRAL Model Law, *supra* note 59, note * (Art. Y).
62. U.C.C. § 4A–507.
63. *Id.* § 4A–507(c).
64. *Id.* § 4A–507(e).
65. *Id.* § 4A–507(a)(1).
66. *Id.* § 4A–105(a)(2).
67. *Report, supra* note 2, at 63.
68. It is important to distinguish finality from mere irrevocability. Saying that a transfer is irrevocable means that the originator no longer has the legal right to cancel the payment order. A payment does not become final until the processing that is conducted by the relevant payments system is complete.

69. U.C.C. § 4A–104(a).

70. *Id.* § 4A–211(c).

71. *See In re Koreag, Contrôle et Révision SA,* 961 F.2d 341 (2d Cir. 1992), *cert. denied,* 113 S.Ct. 188 (1992).

72. Draft Proposal for a European Parliament and Council Directive on Settlement Finality and Collateral Security (undated); *see* European Commission, *Payment Systems: Commission Proposes Directive on Settlement Finality and Collateral Security,* IP/96/467 (June 4, 1996).

73. Draft Proposal for a European Parliament and Council Directive on Settlement Finality and Collateral Security, *supra* note 69, Art. 3.

74. *See Report, supra* note 2, at 24.

75. Federal Deposit Insurance Corporation Improvement Act of 1991, Public Law No. 102-242, § 401 *et seq.*, 105 Stat. 2236 (1991).

76. *Id.* §§ 402–404.

77. *Id.* §§ 403(a) and 404(a).

78. *Id.* § 402(14).

79. *Id.*

80. *Id.* § 402(9).

81. 12 C.F.R. § 231.3 (1995).

82. *Id.*

83. *Lamfalussy Report, supra* note 4.

84. Loi du 22 mars 1993, Art. 157, *cited in Legal Opinions on the Enforceability of the Termination and Close-Out Netting Provisions of the 1992 ISDA Master Agreement* (May 1994); *see also* Philip R. Wood, *Title Finance, Derivatives, Securitisations, Set-off and Netting* 165 *et seq.* (1995).

85. *See* Wood, *supra* note 84, at 165 (citing Bankruptcy Act, § 65.1(7)-(9) (as of 1992)).

86. Loi no. 93–1444 du 31 décembre 1993, Arts. 4 and 8.

87. Insolvenzordnung vom 5. Oktober 1994, § 104, Bundesgesetzblatt I S. 2866; *see also* Wood, *supra* note 84, at 165 (citing Bankruptcy Act of 1879, § 18 and Second Financial Markets Promotion Act 1994, § 15(1)).

88. *See* Wood, *supra* note 84, at 165 (citing Bankruptcy Act, § 38); *see also Legal Opinions on the Enforceability of the Termination and Close-Out Netting Provisions of the 1992 ISDA Master Agreement, supra* note 81.

89. Law of 1995:318 amending the Law of 1991:980 on Trade with Financial Instruments.

90. Bundesgesetz über Schuldbetreibung und Konkurs, Art. 211*bis.*

91. Companies Act, 1989, Chapter 40, Part VII and Schedule 21 (Parts II and III).

92. *See supra* note 75; *see also* 11 U.S.C. §§ 101, 362, 555, 556 (1994); 12 U.S.C. § 1821(e)(8) (1994).

93. A current account is an account in which reciprocal debts and claims are merged and offset or novated either on a continuing basis, that is, as soon as they are entered into, or at agreed periodic intervals.

94. Philip R. Wood, *Principles of International Insolvency* 13-3 at 228 (1995).

95. The Convention on Insolvency Proceedings (the Convention) was opened for signatures from November 23, 1995 to May 23, 1996. Convention, Art. 49(2).

96. Proposal for a Council Directive on the Coordination of Laws, Regulations, and Administrative Provisions Relating to the Reorganization and the Winding-Up of Credit Institutions and Deposit-Guarantee Schemes, 1985 O.J. (C 365) 55, as amended, 1988 O.J. (C 36) 1[hereinafter Winding-Up Directive].

97. Convention, *supra* note 95, Art. 49; *see UK: Politics This Week—Going Mad*, The Economist, May 25, 1996 (noting the United Kingdom refused to sign the EU Bankruptcy Convention).

98. Convention, *supra* note 95, Art. 3(1); Winding-Up Directive, *supra* note 96, Art. 4.

99. Convention, *supra* note 95, Arts. 3(2) and 27.

100. *Id.* Art. 2(h).

101. *Id.* Art. 3(3).

102. *Id.* Art. 1(1).

103. *Id.* Art. 5.

104. *Id.* Art. 6.

105. *Id.* Art. 7.

106. *Id.* Art. 9.

107. *Id.* Art. 10.

108. *Id.* Art. 14.

109. Article 6 provides:

1. The opening of insolvency proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the debtor, where such a set-off is permitted by the law applicable to the insolvent debtor's claim.

2. Paragraph 1 shall not preclude the actions for voidness, voidability or unenforceability laid down in Article 4(2)(m).

Id. Art. 6.

110. Winding-Up Directive, *supra* note 96, Art. 1.

111. *See* letter from Nikolaus Bömcke to Legal Committee and Banking Supervision Committee at 2 (August 23, 1995).

112. *See, e.g.,* 11 U.S.C. § 362 (1994) (regarding the automatic stay in the U.S. Bankruptcy Code).

113. 11 U.S.C. § 362(b)(6), (7), and (17).

114. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Public Law No. 101-73, § 212, 103 Stat. 183, 222 (1989) (amending 12 U.S.C. § 1821).

115. 12 U.S.C. § 1821(e)(8)(D)(i) (1994).

116. Definition of Qualified Financial Contracts, 60 Federal Register 66,863 (1995) (to be codified at 12 Code of Federal Regulations part 360).

117. 12 U.S.C. § 1821(e)(8)(A) (1994).

118. *See* 11 U.S.C. § 109 (1994).

119. *Id.* § 362.

120. *Id.* § 362(b).

121. *Id.* § 362(b)(6), (7), and (17).

122. *Id.*

123. Randall D. Guynn, *Modernizing Securities Ownership, Transfer and Pledging Laws* 5 (paper presented at the Annual Meeting of the International Bar Association, October 13, 1994).

124. *Id.*

125. *Id.* at 9.

126. U.C.C. Revised Article 8: Investment Securities (1995).

127. *See* Guynn, *supra* note 123, at 43–45.

128. *See id.* at 11–12.

129. *Report, supra* note 2, at 2, 32.

130. *Id.*

Chapter **4,** Comment (Sims and Steigerwald)

1. Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries, *Bank of International Settlements, Settlement Risk in Foreign Exchange Transactions* (March 1996) [hereinafter *Report*].

2. *Id.* at 64.
3. *Id.* at 63.
4. *Id.* at 64.
5. *Id.* at 63.
6. *Id.* at 18 *et seq.*
7. *Id.* at 51 (Appendix 2). The recommendations of the Foreign Exchange Committee are reprinted herein as Appendix II (1).
8. *Id.* at 18 *et seq.*
9. *Id.* at 63 (Appendix 4).
10. *Id.* at 64.
11. *Id.*
12. *See* Basle Committee on Banking Supervision, *Report on International Convergence of Capital Measurement and Capital Standards* Annex 3 (July 1988), *reprinted in* 1 *Current Legal Issues Affecting Central Banks* 487, 512 (Robert C. Effros ed., 1992).

However, the risk-based capital rules set out in the Basle Capital Accord of 1988 do not take account of payments netting. Basle Committee on Banking Supervision, *Basle Capital Accord: Treatment of Potential Exposure for Off-Balance Sheet items* Annex at note 6 (April 1995), *reprinted in* 4 *Current Legal Issues Affecting Central Banks* 799, 802 note 6 (Robert C. Effros ed., 1997).

13. *Report, supra* note 1, at 64.
14. The Exchange Clearing House, Limited, based in London, is for the netting of spot and forward foreign exchange obligations.
15. A group of banks based in Canada and the United States propose to establish a foreign exchange clearing house to provide multilateral netting and settlement of spot and forward foreign exchange transactions. The Multinet clearing house would operate as a bank and would be owned by its member banks. The banks in the Multinet project currently net their mutual transactions on a bilateral basis (the VALUNET arrangement). *Report, supra* note 1, at 16 (note 12).
16. *Id.* at 32 (setting forth the "next steps" that can be taken by individual banks, industry groups, and central banks).
17. British Bankers' Association and The Foreign Exchange Committee, *International Foreign Exchange Master Agreement (IFEMA)* (November 1993), *reprinted in* 4 *Current Legal Issues Affecting Central Banks, supra* note 12, at 683; *see* Financial Markets Lawyers Group, *Legal Opinions on the Enforceability of the Termination and Close-Out Netting Provisions of IFEMA* (December 1995).
18. The British Bankers' Association and The Foreign Exchange Committee, *International Currency Options Market (ICOM) Master Agreement and Guide* (April 1992). The *ICOM Master Agreement* is reprinted in 4 *Current Legal Issues Affecting Central Banks, supra* note 12, at 701.
19. International Swap Dealers Association, *ISDA Master Agreement* (1992), *reprinted in* 4 *Current Legal Issues Affecting Central Banks, supra* note 12, at 718.
20. *Report, supra* note 1, at 63.
21. Financial Markets Lawyers Group, *supra* note 17.
22. Federal Deposit Insurance Corporation Improvement Act of 1991, Public Law No. 102-242, § 404(a), 105 Stat. 2236 (1991) [hereinafter FDICIA].
23. "FXNET is a limited partnership owned by the UK subsidiaries of 12 major banks." *Report, supra* note 1, at 15 (note 9).
24. *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* 26 *et seq.* (November 1990). The Lamfalussy standards, as the standards set forth in this report are commonly known, are reprinted in 4 *Current Legal Issues Affecting Central Banks, supra* note 12, at 797.
25. FDICIA, *supra* note 22, §§ 401 *et seq.*

26. *Id.* §§ 403(a), 404(a). Some regulators and legal experts disagree that FDICIA supersedes bankruptcy law in all respects. *See* FDIC Policy Statement, 59 Federal Register 37726, 37730 (1994).

27. 12 U.S.C. § 1821(e)(8)(A) (1994) (applicable to insured banks); 11 U.S.C. § 362 (1994) (applicable to corporate entities).

28. *Id.*

29. 12 U.S.C. § 1821(e)(8)(D)(iv) (1994); 11 U.S.C. § 101(25) (1994).

30. *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries, supra* note 24, at 26. Standard IV provides "[m]ultilateral netting systems should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single net-debit position." *Id.*

31. Uniform Commercial Code § 9-203 ("Attachment and Enforceability of Security Interest; Proceeds; Formal Requisites") (1990).

32. *See id.* § 9-303 ("When Security Interest Is Perfected; Continuity of Perfection").

33. *See* 11 U.S.C. § 101(54) (1994) (defining "transfer" as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption").

34. *See* 11 U.S.C. § 547 (1994); Insolvency Act, 1986, Chapter 45, § 239 (U.K.).

35. *See* 11 U.S.C. § 548(a)(2) (1994); Insolvency Act, 1986, Chapter 45, § 238 (U.K.).

36. *See* 11 U.S.C. § 548(a)(1) (1994).

37. *See id.* § 362.

38. *See* John P. Emert, *The Significance of the International Foreign Exchange Master Agreement (IFEMA), in* 4 *Current Legal Issues Affecting Central Banks, supra* note 12, at 441; Raj Bhala, *Comment, in* 4 *Current Legal Issues Affecting Central Banks, supra,* at 458.

39. FDICIA, *supra* note 22, §§ 403, 404.

40. *Report*, *supra* note 1, at 63–64.

41. *See* 11 U.S.C. § 547; Insolvency Act, 1986, Chapter 45, § 239 (U.K.).

42. *See* 11 U.S.C. § 548(a)(2); Insolvency Act, 1986, Chapter 45, § 238 (U.K.).

43. *See* 11 U.S.C. § 362.

44. *See supra* the text accompanying note 40.

45. Uniform Commercial Code § 2–201 (1990). A proposed revision of Article 2 of the Uniform Commercial Code would repeal the statute of frauds. However, a motion to repeal the statue of frauds for the sale of goods was defeated at the 1997 annual meeting of the American Law Institute.

46. *See* The Foreign Exchange Committee, *Reducing Foreign Exchange Settlement Risk* 5 (1994), *reprinted in part as* Appendix II (6).

47. *See supra* note 24.

48. *Reducing Foreign Exchange Settlement Risk, supra* note 46, at 5.

49. *IFEMA, supra* note 17.

50. Financial Markets Lawyers Group, *supra* note 17.

51. *Id.*

52. FDICIA, *supra* note 22.

53. *See* Financial Markets Lawyers Group, *supra* note 17, England; *see also* Companies Act, 1989, Chapter 40, Part VII and Schedule 21 (Parts II and III).

54. The Multinet International Bank did begin operations in 1997 as anticipated.

55. *See supra* note 24.

Chapter **5**, "Cross-Border Electronic Banking: Perspectives on Systemic Risk and Sovereignty" (Bhala)

1. I would like to thank Mr. Ramsey Taylor, William and Mary Law School, Class of 1996, for his excellent research assistance.

2. Of course, these are not the only challenges raised by cross-border electronic banking. For example, has such banking caused commercial banks to become obsolete? In other words, is the traditional commercial bank franchise, whose value was based on its ability to do what no other institution could do—namely, take deposits and make loans, a dinosaur? After all, technology makes further disintermediation away from banks possible. Consider the payments system. Traditionally, a central bank was the core of this system, and the system was the exclusive province of banks. Now, companies that have nothing to do with a central bank, such as Microsoft, can offer customers the ability to make electronic payments.

3. *See* Adam Smith, *The Wealth of Nations* Book IV, Chapter I (1776).

4. The two public policy concerns noted above are by no means exhaustive. For instance, another important matter is protecting the "small person," that is, the ordinary retail bank customer. He or she needs protection from the risks associated with electronic technology. For example, the customer's deposits and investments must be protected from the risk of fraud perpetrated by electronic pirates.

5. *See generally* Jeffrey B. Ritter, *Defining International Electronic Commerce*, 13 Northwestern Journal of International Law & Business 3 (1992) (discussing the uses of electronic technologies in international commerce).

6. *See* Raj Bhala, *A Pragmatic Strategy for the Scope of Sales Law, the Statute of Frauds, and the Global Currency Bazaar*, 72 Denver University Law Review 1, 16–18 (1994).

7. Amelia H. Boss, *The Emerging Law of International Electronic Commerce*, 6 Temple International and Comparative Law Journal 293, 295, note 5 (1992).

8. *See* Paul Todd, *Dematerialisation of International Trade Instruments*, *in Cross-Border Electronic Banking* 105 (Joseph J. Norton, Chris Reed, and Ian Walden eds., 1995).

9. Boss, *supra* note 7, at 294 (using similar language to define electronic data interchange).

10. *The War of the Wires*, The Economist, May 11, 1996, at 59, 60.

11. *See* Ernest T. Patrikis, Thomas C. Baxter, Jr., and Raj Bhala, *Wire Transfers* 173–177 (1993).

12. With respect to turnover volume in the foreign exchange market, see Bank for International Settlements, *Central Bank Survey of Foreign Exchange Market Activity in April 1995: Preliminary Global Findings,* Press Communiqué (October 24, 1995). After adjusting for double counting, the Bank for International Settlements estimates that the average daily turnover of spot, forward, and swap contracts is $1.230 trillion. This figure excludes currency options. *See also Big*, The Economist, September 23, 1995, at 63 (discussing the estimates). The Bank for International Settlements' previous survey of trading volumes in the foreign exchange market yielded similar results, though a comparison of the two sets of results indicates the market has continued to grow in size at an impressive rate. *See* Monetary and Economic Department, Bank for International Settlements, *Central Bank Survey of Foreign Exchange Market Activity in April 1992* at 1, 5, and 6, Table I (March 1993) (noting gross average daily turnover of approximately $1 trillion, including trading in all over-the-counter instruments, namely, spots, forwards, and derivatives (options and currency swaps) as well as exchange-traded derivatives (options and futures), but excluding cross-currency interest rate swaps).

13. *See* Frances Williams, *WTO Predicts Robust Trade Growth, Despite Slowdown*, Financial Times, March 28, 1996, at 14.

14. *See* Raj Bhala, *The Inverted Pyramid of Wire Transfer Law*, 82 Kentucky Law Journal 347 (1993); *Paying for the Deal: An Analysis of Wire Transfer Law and International Financial Market Interest Groups*, 42 University of Kansas Law Review 667 (1994).

15. Euroclear is a clearinghouse that was set up to settle eurobond trades, but it has come to handle all types of international securities. *See* Margaret Morris, *Settlement and Clearing: A Tale of Gallant Bond Rivals*, Financial Times, June 10, 1996, at 6.

16. *See* Ernest Patrikis, *Delivery Against Payment,* 4 *Current Legal Issues Affecting Central Banks* 555 (Robert C. Effros ed., 1997).

17. *Hazell v. Hammersmith and Fulham London Borough Council,* 2 Appeal Cases 1 (House of Lords 1992); *see* William Blair, *Banking Law Developments in the United Kingdom,* 4 *Current Legal Issues Affecting Central Banks, supra* note 16, at 235.

18. UNCITRAL Model Law on International Credit Transfers, November 25, 1992, *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 312 (Robert C. Effros ed., 1994).

19. Uniform Commercial Code, Article 4A ("Funds Transfers") (1989), *reprinted in* 1 *Current Legal Issues Affecting Central Banks* 515 (Robert C. Effros ed., 1992).

20. *See* Patrikis, Baxter, and Bhala, *supra* note 11.

21. Patrikis, *supra* note 16, at 560–561; *see also* Robert C. Effros, *A Banker's Primer on the Law of Electronic Funds Transfers,* 105 Banking Law Journal 510, 539 (1988).

22. Basle Committee on Banking Supervision, *Report on International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended); Basle Committee on Banking Supervision, *Amendment to the Capital Accord to Incorporate Market Risks* (January 1996); *see* Raj Bhala, *Equilibrium Theory, the FICAS Model, and International Banking Law*, 38 Harvard International Law Journal 1 (1997); *Applying Equilibrium Theory in the FICAS Model: A Case Study of Capital Adequacy and Currency Trading*, 41 St. Louis University Law Journal 125 (1996).

23. Unfortunately, however, the self-regulatory emerging market risk scheme does not extend to securities firms. An agreement between the Basle Supervisors Committee and the International Organization of Securities Commissioners is necessary to cure the disjointed regulatory approach to computer models devised by investment professionals to monitor and reduce market risk. In addition, coordinated enforcement of such an agreement is required. Repeats of the lack of candor among regulators that occurred during the BCCI and Daiwa affairs must not occur.

24. Derivatives Policy Group, *Framework for Voluntary Oversight* 23 *et seq.* (March 1995).

25. *Id.* at 13 *et seq.*

26. Gregory J. Millman, *The Vandals' Crown* (1995).

27. Of course, proper structural and fiscal policies, which are outside the purview of a central bank, also are important safeguards against a run.

28. *Restatement (Third) of the Foreign Relations Law of the United States* § 401 (1987) [hereinafter *Restatement*].

29. *See* Louis Henkin *et al.*, *International Law: Cases and Materials* chapter 12 (3rd ed., 1993); Ian Brownlie, *Principles of Public International Law* chapters 6, 13, and 14 (4th ed., 1990); 1 *Restatement, supra* note 28, part 4.

Except for the universality principle, each jurisdictional basis is subject to a limitation of "reasonableness." *Restatement, supra,* § 403(1). A state may not exercise jurisdiction with respect to a person or activity that has connections with another state when exercise of such jurisdiction is unreasonable. *Id.* Section 403 of the *Restatement* also lists criteria to help determine when exercising jurisdiction is unreasonable. *Id.* § 403(2). These criteria include factual matters and the concerns of the parties and other states.

In addition to the territory, effects, and nationality principles, a jurisdictional claim may be supported by the protective or universality principles. However, these principles are largely irrelevant to the context of cross-border electronic banking. The protective principle indicates a state has jurisdiction with respect to conduct outside its territory committed by persons that are not its nationals if that conduct is directed against the security of the state or a limited class of its interests. It is unlikely a central bank can make a credible jurisdictional claim on "national security" grounds. The universality principle gives every state jurisdiction to prescribe law and punishment for crimes of universal concerns, namely, pira-

cy, slave trade, hijacking, genocide, war crimes, and—perhaps—terrorism. No other basis of jurisdiction is needed. Unless a central bank could claim that a cross-border electronic banking transaction is the means to facilitate one of these universally condemned crimes, then this basis of jurisdiction is irrelevant.

Finally, as discussed in the text below, a jurisdictional claim may be supported by the consent principle.

30. *See, e.g., Restatement, supra* note 28, § 402(1)(a), (b).

31. *See, e.g., id.* § 402(1)(c).

32. *See, e.g., id.* § 402(1)(a).

33. *See* Henkin *et al., supra* note 29, at 1054–1055.

34. *See Restatement, supra* note 28, §§ 414(1) (providing "a state may exercise jurisdiction to prescribe for limited purposes with respect to activities of foreign branches of corporations organized under its laws") and 414(2) (providing that "[a] state may not ordinarily regulate the activities of corporations organized under the laws of a foreign state on the basis that they are owned or controlled by the nationals of the regulating state.").

35. 2 Joseph Gold, *The Fund Agreement in the Courts: Volume II* 391 *et seq.* (1982); F.A. Mann, *The Legal Aspect of Money* 237 *et seq.* (2d ed. 1953).

36. *Libyan Arab Foreign Bank v. Bankers Trust,* 1 Queen's Bench 728 (1989); *see* Blair, *supra* note 17.

37. Gold, *supra* note 35, at 392.

38. *Restatement, supra* note 28, § 403.

39. *See* Patrikis, Baxter, and Bhala, *supra* note 11, at 203–209 (discussing the CHIPS settlement account at the Federal Reserve Bank of New York).

40. *See, e.g.*, Hal Scott, *Where Are the Dollars?—Off-Shore Funds Transfers*, 3 Banking and Finance Law Review 243 (June 1989).

41. Board of Governors of the Federal Reserve System, *Policy Statement on Privately Operated Large-Dollar Multilateral Netting Systems*, IV Federal Reserve Regulatory Service 9–1021–1022.3 at 9.360-364.1 (October 1995).

42. *Id.* § 9–1022 at 9.361.

43. Basle Committee on Banking Supervision, *Report On International Developments in Banking Supervision* Chapter III (Report number 8, September 1992) ("*Strengthening International Cooperation Between Banking Supervisory Authorities*"), *reprinted in* 3 *Current Legal Issues Affecting Central Banks* 301 (Robert C. Effros ed., 1995).

Chapter **5,** Comment (Byrne)

1. Chapter 5 suggests the definition used by Amelia H. Boss: "the computer to computer exchange of information in predetermined formats," Amelia H. Boss, *The Emerging Law of International Electronic Commerce*, 6 Temple Int'l and Comp. L. J. 293, 294 (1992) (citing *The Legal Position of the Member States with Respect to Electronic Data Interchange, TEDIS Final Report* (Commission of the European Communities, Brussels, Belgium, September 1989) at 27, 28). While this "definition" may serve as a description of wholesale banking uses currently in place, it is not accurate regarding current banking practices in general. *See* Allen H. Lipis, Thomas R. Marschall, and Jan H. Linker, *Electronic Banking* (1985) (covering the gamut of consumer and retail banking uses, very few of which are computer-to-computer transactions and some of which are automated (for example, telephone to computer)). Even within the sphere of wholesale funds transfers, the scope of legislation in U.S. Uniform Commercial Code [U.C.C.] Article 4A is sufficiently broad to encompass within the meaning of a "payment order" (and so a "funds transfer," which is a series of such orders) oral and written orders. U.C.C. §§ 4A–103, 4A–104 (1990). It is also questionable whether future systems will require that the data be formatted. Article 4A is reprinted in 1 *Current Legal Issues Affecting Central Banks* 515 (Robert C. Effros ed., 1992).

2. Chapter 5 points to six components of systemic risk: credit risk, market risk, market liquidity risk, payments or settlement risk, operational risk, and legal risk. Raj Bhala, *Cross-Border Electronic Banking: Perspectives on Systemic Risk and Sovereignty, supra,* at 107. This classification may include country risk or political risk but, if not, it should be classified in the formula. In addition, there is the issue of illegality/public policy that may or may not fit within the notion of legal risk.

3. The United States has accommodated its financial system to its foreign policy. Examples include restrictions imposed under trading with the enemy laws with regimes deemed adverse to the interests of the United States (Libya, Sudan, Iran, Iraq, North Korea, and Cuba, to name a few); antiboycott provisions that are focused on the Arab boycott of Israel; provisions designed to prevent the proliferation of technology related to missile delivery systems and nuclear weapons as well as other selected weapons-related technologies; and provisions on money laundering. Pursuant to statutes and regulations, banks are required to monitor transactions, report them, and otherwise cooperate with a series of regulators. The provisions are enforced with stiff fines. At the present time, most banks have compliance officers who oversee compliance with these regulations as well as counsel specially trained in these provisions.

4. *See supra* note 1.

5. UNCITRAL Model Law on Electronic Commerce, *in Report of the United Nations Commission on International Trade Law on the Work of Its Twenty-Ninth Session* (May 28–June 14, 1996), General Assembly Official Records, 51st Session, Supplement No. 17, UN Doc. A/51/17 (1996). The most useful summary of EFT to date is contained in *UNCITRAL Legal Guide on Electronic Funds Transfers,* UN Doc. A/CN.9/SER.B/1, UN Sales No. E.87.V.9 (1987).

6. Basle Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended). *See, for example, Capital; Risk-Based Capital Guidelines*, 12 Code of Federal Regulations parts 208, 225 (1995) (as adopted by the Board of Governors of the Federal Reserve System).

7. There has been no exhaustive study of the reasons for this phenomenon, but the statistics reveal an upward trend that has leveled off at the time of implementation of the capital adequacy guidelines. These figures are published quarterly in *Documentary Credit World.*

8. Bhala, *supra* note 2, p. 110.

9. International Chamber of Commerce, *ICC Uniform Customs and Practice for Documentary Credits* (January 1, 1994). Rules are being developed that will provide the same framework of practice for standby letters of credit—the International Standby Practices (ISP). The current draft of the ISP is published in the November–December 1997 issues of *Documentary Credit World.*

10. The two most recent statutory efforts in the field are designed to complement the UCP and other rules of practice, such as the nascent ISP (International Standby Practices), *see supra* note 11; U.C.C. Revised Article 5 (1995); UN Convention on Independent Guarantees and Stand-by Letters of Credit, New York, December 11, 1995, annexed to General Assembly Resolution 50/48, UN GAOR, 50th Session, 87 plenary meeting, 24 UNCITRAL Yearbook 59 (1995). For judicial deference, *see Alaska Textile Co., Inc. v. Chase Manhattan Bank, N.A.,* 982 F.2d 813 (2nd Cir. 1992).

11. U.C.C. § 4A–501(b).

12. *Id.*

13. *Id.* at Official Comment 1.

14. *Id.* § 4A–501(b).

15. UNCITRAL Model Law on International Credit Transfers, November 25, 1992, *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 312 (Robert C. Effros ed., 1994).

Afterword to Chapters **4** and **5** Baxter

1. *See, e.g., In re Koreag, Contrôle et Révision SA,* 961 F.2d 341 (2d Cir. 1992), *cert. denied,* 113 S. Ct. 188 (1992); *see also* Thomas C. Baxter, Jr. and James H. Fries, Jr., *Resolving Funds Transfer Disputes Related to Currency Exchange Transactions: What Law Governs?*, 1995 Commercial Law Annual 297 (1995).
2. Uniform Commercial Code § 2-702(2) (1990).
3. UNCITRAL Model Law on International Credit Transfers, November 25, 1992, *reprinted* in 2 *Current Legal Issues Affecting Central Banks* 312 (Robert C. Effros ed., 1994).

Foreword to Chapters **6** and **7** (Ireland)

1. *See, e.g.*, Congressional Budget Office, The Congress of the United States, *Emerging Electronic Methods for Making Retail Payments* (June 1996).
2. *See id.* This study notes that, according to one estimate, "worldwide sales on the Internet total more than $300 million a year and the number is growing." *Id.* at 25 (footnote omitted).
3. Uniform Commercial Code [U.C.C.], Article 3 (Commercial Paper), § 3–310(b) (1996).
4. *Id.* § 3–310 (a).

Chapter **6,** "Stored Value Products: A New Legal Challenge" (Baxter)

1. This chapter was prepared with the assistance of Stephanie Heller, Counsel, and Colleen Westbrook, Attorney, Federal Reserve Bank of New York.
2. Many of the views expressed in this chapter were developed in the context of an American Bar Association task force on electronic money.
3. The abbreviation IOU stands for "I owe you," meaning an individual owes a debt to another.
4. *See* Uniform Commercial Code [U.C.C.], Article 3 (Negotiable Instruments), § 3-310(b).
5. *Id.* § 3-310(a).
6. *Id.* Article 2 (Sales), § 2-702(2).
7. *Id.* §§ 2–102, 2–105(1); *see* Thomas C. Baxter, Jr. and James H. Freis, Jr., *Resolving Funds Transfer Disputes Related to Currency Exchange Transactions: What Law Governs?,* 1995 Commercial Law Annual 297 (1995).
8. U.C.C. § 3–312.
9. *Id.* § 4–403.

Chapter **6,** Comment (Heinrich)

1. In early 1996, electronic purse schemes were either running as live pilot projects or were in development in several European countries, including Austria, Belgium, Denmark, Finland, Germany, The Netherlands, Portugal, Russia, Spain, Sweden, and the United Kingdom. Such schemes were also in development or operating in Australia, Brazil, Canada, China, Nigeria, South Africa, and the United States.

For an overview on existing "e-money" schemes and projects, *see World Survey of Cyberpayment Systems, in Exploring the World of Cyberpayments* Appendix III (a colloquium sponsored by the Financial Crimes Enforcement Network, U.S. Department of Treasury) (September 27, 1995).

2. Detlef Kröger, Ralf Clasen and Dirk Wallbrecht, *Internet für Juristen - Weltweiter Zugriff auf juristische Informationen* 12–13 (1996).

3. *See* Bank for International Settlements, *Statistics on Payment Systems in the Group of Ten Countries* (December 1994); *Payment Systems in the Group of Ten Countries* (December 1993); *Payment Systems in Eleven Developed Countries* (April 1989).

4. *See* Congressional Budget Office, Congress of the United States, *Emerging Electronic Methods for Making Retail Payments* 45 (June 1996) (noting "[s]eigniorage is the government's profit from the manufacture of coins; the profit is the difference between the face value of the coins and the cost of producing them" and recognizing "[w]idespread use of stored-value cards and on-line scrip could eventually lower the demand for cash, reducing the government's income if the new payment methods replaced substantial holdings of coin and currency").

5. Central bank liabilities in the form of banknotes are not interest bearing, whereas the corresponding assets are typically held in the form of domestic government securities.

6. The CPSS is currently chaired by Mr. William McDonough, President of the Federal Reserve Bank of New York, and the Secretariat is provided by the Bank for International Settlements.

7. As of August 1997, there is little legal literature on e-money. *But see* Bank for International Settlements, *Implications for Central Banks of the Development of Electronic Money* (October 1996) (availabe at http://www.bis.org); Manfred Borchert, *Cyber-Money —eine neue Währung?* Sparkasse, January 1996, at 41; Mark E. Budnitz, *Stored Value Cards and the Consumer: The Need for Regulation,* 46 American University Law Review [Am. U. L. Rev.] 1027 (1997); Shameela Chinoy, *Electronic Money in Electronic Purses and Wallets,* 12 Banking and Finance Law Review 15 (1996); European Committee for Banking Standards (ECBS), *ECBS Technical Report —TR 103—Banking Sector Requirements for an Electronic Purse* (December 1995); ECBS, *ECBS Technical Report—DTR 401—Secure Banking over the Internet* (January 1997); Paul W. Bauer, *Making Payments in Cyberspace,* Economic Commentary (Federal Reserve Bank of Cleveland) (October 1, 1995); R.E. de Rooy, *De chipknip: een (juridische) verkenning,* Nederlanse Juristenblad, April 5, 1996, at 509; Walter A. Effross, *Piracy, Privacy, and Privatization: Fictional and Legal Approaches to the Electronic Future of Cash,* 46 Am. U. L. Rev. 961 (1997); Federal Deposit Insurance Corporation, *General Counsel's Opinion No. 8: Stored Value Cards,* 61 Federal Register 40,490 (August 2, 1996); Richard L. Field, *1996: Survey of the Year's Developments in Electronic Cash Law and the Laws Affecting Electronic Banking in the United States,* 46 AM.U. L. Rev. 967 (1997); Group of Ten, *Electronic Money - Consumer Protection, Law Enforcement, Supervisory and Cross Border Issues* (April 1997) (available at http://www.bis.org); Laurie Law, Susan Sabett, and Jerry Solinas, *How to Make a Mint: The Cryptography of Anonymous Electronic Cash,* 46 Am. U. L. Rev. 1131 (1997); Peter Ledingham, *Pre-paid Cards,* 57 Reserve Bank Bulletin (New Zealand) 346 (1994); Simon Lelieveldt, *How to Regulate Electronic Cash: An Overview of Regulatory Issues and Strategies,* 46 Am. U. L. Rev. 1163 (1997); Steven Levy, *E-money (That's What I Want),* Wired 174 (December 1994); Gary W. Lorenz, *Electronic Stored Value Payment Systems, Market Position, and Regulatory Issues,* 46 Am. U. L. Rev. 1177 (1997); David G. Oedel, *Why Regulate Cybermoney?,* 46 Am. U. L. Rev. 1075 (1997); Brian W. Smith and Ramsey J. Wilson, *How Best to Guide the Evolution of Electronic Currency Law,* 46 Am. U. L. Rev. 1105 (1997); John Wenninger and Daniel Orlow, *Consumer Payments over Open Computer Networks,* Federal Reserve Bank of New York Research Paper No. 9603 (March 1996); Working Group on EU Payment Systems, *Report to the Council of the European Monetary Institute on Prepaid Cards* (May 1994); John D. Wright, *Smart Cards: Legal and Regulatory Challenges,* Bankers Magazine, March/April 1996, at 24. A bibliography of articles on electronic purses may be found at http://cfec.vub.ac.be/cfec/purses.htm.

Chapter 6, Comment (Ballen)

1. 15 U.S.C. § 1693g (1994).

2. These concerns might have to be addressed in other contexts such as the reconstruction of transactions that might be made by an issuing institution to provide a remedy in the event of malfunction of a terminal. *See infra* the Answer to Hypothetical Number 2: Terminal Malfunction.

3. 31 U.S.C. § 5103 (1994).

Chapter 7, "Checks and Check Collection: A Comparison between the Common Law and Geneva Systems" (Guest)

1. I wish to acknowledge the very considerable assistance that I have received from Professor E.P. Ellinger, National University of Singapore, in the preparation of this paper.

2. Bills of Exchange Act, 1882, 45 and 46 Vict., Chapter 61 [hereinafter B.E.A.].

3. Uniform Commercial Code [U.C.C.] (West Publishing, 12th ed. 1991). This chapter refers to Article 3, Negotiable Instruments, which was recently revised and replaced by Article 3, Commercial Paper.

4. *Id.* § 3–104(e).

5. *Id.* § 3–104(g).

6. *Id.* § 3–104(h).

7. The Geneva system consists of the following conventions, which were all signed in Geneva: Convention Providing a Uniform Law for Bills of Exchange and Promissory Notes, June 7, 1930; Convention for the Settlement of Certain Conflicts of Laws in Connection with Bills of Exchange and Promissory Notes, June 7, 1930; Convention on the Stamp Laws in Connection with Bills of Exchange and Promissory Notes, June 7, 1930; Convention Providing a Uniform Law for Cheques, March 19, 1931; Convention for the Settlement of Certain Conflicts of Laws in Connection with Cheques, March 19, 1931; and Convention on the Stamp Laws in Connection with Cheques, March 19, 1931. These conventions may be found in 1 *Register of Texts of Conventions and Other Instruments Concerning International Trade Law* 154 *et seq.,* UN Sales No. E.71.V.3 (1971).

8. Uniform Law on Cheques, Annex I to the Convention Providing a Uniform Law for Cheques, March 19, 1931, 143 League of Nations Treaty Series 357 (1933–34), *reprinted in* 1 *Register of Text of Conventions and Other Instruments Concerning International Trade Law, supra* note 7, at 192, 195.

9. Convention Providing a Uniform Law for Cheques, *supra* note 8, Annex II.

10. *See* Reservations and Declarations, attached to the Convention Providing a Uniform Law for Cheques, *supra* note 8.

11. *United Dominions Trust Ltd. v. Kirkwood* [1966] 2 Queen's Bench [Q.B.] 431.

12. B.E.A. § 73; U.C.C. § 3–104(f).

13. "Banker" is defined to include "a body of persons whether incorporated or not who carry on the business of banking." *Id.* § 2.

14. *See* B.E.A. § 13; U.C.C. § 3–113(a).

15. B.E.A. § 53(1).

16. Annex II to the Convention Providing a Uniform Law for Cheques, *supra* note 8, Art. 5.

17. Décret-loi du 30 octobre 1935 unifiant le droit en matière de chèques, Art. 3.

18. Annex II to the Convention Providing a Uniform Law for Cheques, *supra* note 8, Art. 19.

19. Décret-loi du 30 octobre 1935 unifiant le droit en matière de chèques, Art. 17.

20. *See* Scheckgesetz vom 14. August 1933, Art. 3.
21. B.E.A. § 8(1).
22. Cheques Act, 1992, Chapter 32, § 1.
23. Uniform Law on Cheques, *supra* note 8, Art. 14.
24. [1944] Appeal Cases 176.
25. U.C.C. § 3–409(d).
26. *Id.*
27. [1993] 3 All England Reports [All E.R.] 789.
28. Uniform Law on Cheques, *supra* note 8, Art. 29.
29. *Id.*
30. *Barclays Bank plc v. Bank of England,* [1985] 1 All E.R. 385.
31. Annex II to the Convention Providing a Uniform Law for Cheques, *supra* note 8, Art. 16.
32. Cheques Act, 1992, *supra* note 22, § 1.
33. Bills of Exchange (Amendment) Act, 1992 (enacting Section 81A of the Bills of Exchange Act).
34. Cheques Act, 1957, 5 and 6 Eliz., Chapter 36, § 1(2)(b).
35. *Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd.* [1986] A.C. 80.
36. *Id.* at 109–110.
37. *London Joint Stock Bank Ltd. v. Macmillan and Arthur* [1918] A.C. 777.
38. Cheques Act, 1957, *supra* note 34, § 1.
39. U.C.C. § 4–401(a).
40. *But see id.* § 4–205 (relating to unindorsed items).
41. Cheques Act, 1957, *supra* note 34, § 4.
42. U.C.C. § 3-420(a).
43. B.E.A. §§ 74B and 74C (introduced by the Deregulation (Bills of Exchange) Order 1996, 1996 Statutory Instruments No. 2993).
44. Cheques Act, 1957, *supra* note 34, § 2(2).

Chapter 7, Comment (Kimball)

1. *See* Agreement on Truncated Cheque Collection (BSE Agreement); Agreement Concerning the Truncated Cheque Collection of Equivalents of DM 5,000 and Above (Large-Value Cheques); and the Separate Submission of the Original Cheques Without Settlement (BSE Agreement).
2. *See* Ignacio Lojendio Osborne, *Spain, in Payment Systems of the World* 279, 289 (Robert C. Effros ed., 1994).
3. *See* Federal Reserve Bank of Boston, *Electronic Check Presentment Services,* Operating Letter No. 6A (January 1, 1996).

Chapter 7, Comment (Clark)

1. MICR is the acronym for "machine-readable magnetic ink character recognition."
2. Uniform Commercial Code [U.C.C.], Article 3 (Negotiable Instruments), §§ 3–103(a)(7), 3–406(b), 4–406(e) (West Publishing, 12th ed. 1991); *see* U.C.C., Article 3 (Commercial Paper), §§ 3–406, 4–103(3) (1996).
3. 12 Code of Federal Regulations [C.F.R.] part 205 (1997) (regarding electronic funds transfers).
4. *See id.* § 205.10 (regarding preauthorized transfers).
5. U.C.C. § 3–405 (1990).
6. *Id.*
7. 12 C.F.R. §§ 229.2(z), 229.33.

Afterword to Chapters 6 and 7 (Ireland)

1. 15 U.S.C. §§ 1601 *et seq.* (1994).

2. 12 U.S.C. §§ 4301 *et seq.* (1994).

Chapter 8, "Comparative Banking Supervision" (Feldberg)

1. The Group of Seven countries are Canada, France, Germany, Italy, Japan, the United States, and the United Kingdom.

2. Federal Deposit Insurance Corporation Improvement Act of 1991, § 112, 12 U.S.C. § 1831m(c) (1994).

3. Reserve Bank of New Zealand, *Reserve Bank's Banking Supervision Policy Conclusions* (December 22, 1994), *attached to* Letter of Governor D.T. Brash to the Basle Committee on Banking Supervision (February 1, 1995); *see New Disclosure Regime for Banks* (May 22, 1996). The last document may be found at the Reserve Bank of New Zealand's home page: www.rbnz.govt.nz/.

4. *See* Steven A. Miller, *How Daiwa Self-Destructed,* Banking Law Journal 560 (June 1996).

5. *See* Board of Banking Supervision, *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings* (July 18, 1995).

6. Basle Committee on Banking Supervision, *Report on International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended).

7. Basle Committee on Banking Supervision, *Principles for the Management of Interest Rate Risk* (September 1997).

8. Regarding the roles of the various federal agencies, *see U.S. Banking Regulation Roundtable, in* 4 *Current Legal Issues Affecting Central Banks* 173 (Robert C. Effros ed., 1997).

9. Riegle Community Development and Regulatory Improvement Act of 1994, Public Law No. 103–325, § 305, 108 Stat. 2160, 2216 (1994).

10. *See The Basic Elements of Bank Supervision* (Frederick C. Schadrack and Leon Korobow eds., 1993).

11. *See* Susan F. Moore, *The Collection of Banking Statistics, in The Basic Elements of Bank Supervision, supra* note 10, at 45 (explaining the processing of call reports, which consist of detailed condition and income statements).

12. *See* Frederick C. Schadrack, *Resolving Problem Bank Situations, in The Basic Elements of Bank Supervision, supra* note 10, at 85.

13. *See Capital Adequacy Guidelines*, 59 Federal Register 62,987 and 63,241 (1994) (amending 12 Code of Federal Regulations parts 208 and 225).

14. *See Risk-Based Capital Standards*, 59 Federal Register 64,561 (1994) (amending 12 Code of Federal Regulations parts 3, 208, 325, and 567).

15. Board of Governors of the Federal Reserve System, *Federal Reserve Guidelines for Rating Risk Management at State Member Banks and Bank Holding Companies (SR 95-51)* (November 14, 1995); Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, *Trading Activities Manual* (March 1994) (regarding risk management).

16. 12 U.S.C. § 84(a)(1) (1994); *see* Chester B. Feldberg, *The Development and Administration of Key Prudential Policies, in The Basic Elements of Bank Supervision, supra* note 10, at 29, 42.

17. *See herein* Mats A. Josefsson, *Bank Failures in Nordic Countries*, Chapter 9B.

18. *See supra* note 6.

19. Basle Committee on Banking Supervision, *Amendment to the Capital Accord to Incorporate Market Risks* (January 1996); *see* Basle Committee on Banking Supervision, *Overview of the Amendment to the Capital Accord to Incorporate Market Risks* (January 1996).

20. *See* Basle Committee on Banking Supervision, *The Supervisory Treatment of Market Risks* (April 1993); *see also* James Houpt, *International Bank Capital Standards for Market*

Risk: Recent Developments and Possible New Directions, in 4 *Current Legal Issues Affecting Central Banks, supra* note 8, at 577.

21. *See* Thomas Baxter and Jet Joseph de Saram, *BCCI: The Lessons for Banking Supervision, in* 4 *Current Legal Issues Affecting Central Banks, supra* note 8, at 371.

22. Basle Committee on Banking Supervision, *Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments* (June 1992), *reprinted in* 3 *Current Legal Issues Affecting Central Banks* 301 (Robert C. Effros ed., 1995).

23. *See herein* Philip R. Wood, *International Law of Bank Secrecy, infra* Chapter 17.

24. *The Supervision of Cross-Border Banking*, Report by a Working Group Composed of Members of the Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors (October 1996), *reprinted in part as* Appendix III(3).

25. Heads of State and Government of Seven Major Industrialized Nations and the President of the European Commission, *Halifax Summit Communiqué* 5 (June 15–17, 1995).

26. Basle Committee on Banking Supervision and the International Organization of Securities Commissions, *Response of the Basle Committee on Banking Supervision and of the International Organization of Securities Commissions to the Request of the G-7 Heads of Government at the June 1995 Halifax Summit* (May 1996).

27. Tripartite Group of Bank, Securities, and Insurance Regulators, *The Supervision of Financial Conglomerates* (July 1995), *reprinted in part as* Appendix III(2).

28. *Id.* at 16–17.

29. *Id.*

30. *Id.* at 31.

31. *Id.* at 32.

32. *Id.*

33. *See supra* the text accompanying note 19.

Chapter 8, Comment (Schiffman)

1. Conservatorship is the condition of a bank when it is under the control of a conservator who is charged with attempting to rehabilitate a bank, sell it as a going concern, or sell its assets on a wholesale basis. A receivership is the condition of a bank that is under the control of a receiver who is charged basically with selling the bank's assets and settling claims against the bank.

2. Courts in the United States and Canada have held that when a corporation becomes insolvent, the officers and directors assume fiduciary obligations to protect the corporation's assets for creditors. *See, e.g., In re Reuscher,* 169 Bankr. 398 (S.D. Ill. 1994).

3. The law should not contain any structural or normative biases, however. The outcome for an insolvent bank will depend upon which solution the supervisory authority determines would best protect creditors.

4. This is consistent with the treatment of enterprises under modern bankruptcy laws that provide an opportunity for reorganization and retention by shareholders of all or part of their ownership interest in a going concern if they or others recapitalize the company.

5. While a receiver could become involved in option (ii), if the conservator has failed at this, the receiver may not have better prospects. (Note, the conservator and the receiver may also be the same person.)

6. Some ailing banks may receive assistance from the central bank or the government to bolster their liquidity. The efficacy of government rescues may be questionable. *See Please, Governor, Can You Spare a Billion?* The Economist, March 25, 1995, at 79. A bank with prospects for sale or rehabilitation may also be able to borrow to pay its liabilities. High priority in the law for claims of postproceeding creditors in liquidation would facilitate funding.

Chapter 8, Comment (Guardia)

1. Basle Committee on Banking Supervision, *Report on International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended) [Basle Accord]. The Basle Accord is reprinted in 1 *Current Legal Issues Affecting Central Banks* 487 (Robert C. Effros ed., 1992) and amendments thereto are reprinted in volumes 3 (1995) and 4 (1997).

Chapter 9A, "A Central Bank's Perspective" (Ireland)

1. Federal Deposit Insurance Corporation Improvement Act of 1991, Public Law No. 102–242, § 141, 105 Stat. 2236, 2273 (1991).
2. *Id.* §§ 141, 142.
3. *Id.* § 142.
4. *Id.* § 141.
5. Omnibus Budget Reconciliation Act of 1993, Public Law No. 103–66, §3001, *107* Stat. 297, 336 (1993).

Chapter 9B, "Bank Failures in Nordic Countries" (Josefsson)

1. Heikki Koskenkylä, *The Condition of Nordic Banks and Future Prospects Post-Crisis*, Bank of Finland Bulletin No. 8, at 9 (1995).
2. *Id.*
3. *Id.*
4. *Id.*
5. Peter Nyberg and Vesa Vihriälä, *The Finnish Banking Crisis and Its Handling*, Bank of Finland Discussion Papers 8/93, at 26 (1993).
6. *Id.*
7. *See id.* at 28.
8. *Id.* at 38.
9. *Id.*
10. Ministry of Finance, *Ending the Bank Support*, Ds 1995:67, at 12 (1995).
11. *Id.*
12. *Id.* at 13.
13. Nyberg and Vihriälä, *supra* note 5, at 29.
14. *Id.*
15. *Id.*
16. *See* Hans Petter Wilse, *Management of the Banking Crisis and State Ownership of Commercial Banks,* Economic Bulletin (Bank of Norway) 2/95, at 217, 218 (1995).
17. *Id.*
18. *Id.* at 219.
19. Ministry of Finance, *supra* note 10, at 13.
20. *Id.* at 20.
21. *Id.* at 20–21.
22. Koskenkylä, *supra* note 1, at 13; *see* Wilse, *supra* note 16, at 219–223.
23. Koskenkylä, *supra* note 1, at 13; Wilse, *supra* note 16, at 224–226.
24. *See* Nyberg and Vihriälä, *supra* note 5, at 31.
25. Ministry of Finance, *supra* note 10, at 20.
26. Koskenkylä, *supra* note 1, at 14.
27. *Id.*
28. Ministry of Finance, *supra* note 10, at 29.
29. *Id.* at 55.
30. Koskenkylä, *supra* note 1, at 14.
31. *Id.*
32. *Id.* at 14.

33. *See* Basle Committee on Banking Supervision, *Report on International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended in 1992, 1994, 1995, and 1996).

Chapter **9C**, "Bank Failures in Latin America" (Feldman)

1. In this chapter, the concepts of bank failures and banking crises are sometimes used interchangeably, although it is important to distinguish the cases where bank failures did not develop into full-fledged systemic crises in Latin America.

2. In the Mexican case, the absence of deposit runs, particularly after the emergence of the crisis in December 1994, can be linked to the large and unexpected peso devaluation. Depositors caught by the devaluation had already incurred an enormous capital loss. Consequently, it was useless to withdraw funds from the system and, in fact, it paid to remain within the banking system if the expectation (later validated by facts) was that the peso devaluation was an overshot and a subsequent appreciation could follow.

3. Interestingly enough, the experience showed a few months later that many of the banks perceived as healthy were actually in deep trouble. Consequently, a second wave of runs took place, giving way to a new process of deposit redistribution.

4. The loss of confidence that generated the run was related to recent episodes in Argentine financial history. In particular, there was a perceived threat of a deposit freeze. This sentiment led the public to move away from all banks (even from state-owned banks that were normally perceived as enjoying an implicit deposit guarantee) and to seek refuge in currency holdings, both domestic and foreign denominated.

Chapter **9**, Comment (Lindgren)

1. *See* James R. Barth and R. Dan Brumbaugh, Jr., *The Role of Deposit Insurance: Financial System Stability and Moral Hazard*, 4 *Current Legal Issues Affecting Central Banks* 393 (Robert C. Effros ed., 1997).

2. *See* Federal Deposit Insurance Corporation Improvement Act of 1991, Public Law No. 102–242, 105 Stat. 2236 (1991).

3. *See supra* Oliver Ireland, *A Central Bank's Perspective* (Chapter 9A).

4. *See supra* Ernesto V. Feldman, *Bank Failures in Latin America* (Chapter 9C).

5. Ley de Convertibilidad del Austral [Law on the Convertibility of the Austral], Law No. 23.928 of March 27, 1991, Arts. 4, 6 (published March 28, 1991).

6. 12 U.S.C. § 347b(b)(3) (1994 & Supp. I 1995).

Afterword to Chapters **8** and **9** (Guitián)

1. Walter Bagehot, *Lombard Street* (John Murray 1924) (1873).

2. John Stuart Mill, *Principles of Political Economy* (Reprints of Economic Classics, Augustus M. Kelley 1965)(1848).

Foreword to Chapters **10** and **11** (Blair)

1. The author is grateful for the assistance of Christopher D. Olive, Research Fellow at the Centre for Commercial Law Studies, Queen Mary and Westfield College, University of London, in preparing this paper.

2. *See* U.S. General Accounting Office, *Mexico's Financial Crisis: Origins, Awareness, Assistance, and Initial Efforts to Recover*, GAO/GGD-96-56 (February 1996).

3. *See* William Dawkins and Gerard Baker, *Relief over Japan's Budget Vote*, Financial Times, April 12, 1996, at 3.

4. *See* Peter Lee, *A Question of Collateral*, Euromoney 46 (November 1995).

5. *See* Henry N. Schiffman, *Bankruptcy Law and Bank Insolvency Law in Eastern Europe, in* 4 *Current Legal Issues Affecting Central Banks* 437 (Robert C. Effros ed., 1997).

6. *See* Thomas C. Baxter, Jr. and Jet Joseph de Saram, *BCCI: The Lessons for Banking Supervision, in* 4 *Current Legal Issues Affecting Central Banks, supra* note 5, at 371.

7. Financial Institutions Reform, Recovery, and Enforcement Act of 1989 § 201 *et seq.*, 12 U.S.C. § 1811 *et seq.* (1994).

8. 12 U.S.C. § 1821(k) (1994).

9. *See, e.g., FDIC v. McSweeny*, 976 F.2d 532 (9th Cir. 1992), *cert. denied*, 133 S.Ct. 2440 (1993); *FDIC v. Fay*, 779 F. Supp. 66 (S.D. Tex. 1991); *Resolution Trust Corp. v. Dean*, 854 F. Supp. 626 (D. Ariz. 1994).

10. Board of Banking Supervision, *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings* (July 18, 1995).

11. *Baring Futures (Singapore) Ptd Ltd: The Report of the Inspectors Appointed by the Minister of Finance* (1995).

12. *See* Steven A. Miller, *How Daiwa Self-Destructed*, Banking Law Journal 560 (June 1996).

13. *See The Daiwa Bank Indictment: Full Text of the U.S. Prosecutors' Case*, 23 International Currency Review 3 (1995–96).

14. *See* Miller, *supra* note 12, at 560–561.

15. Commodity Futures Trading Commission, *OTC Derivatives Markets and Their Regulation* (October 1993).

16. U.S. General Accounting Office, *Financial Derivatives: Actions Needed to Protect the Financial System*, GAO/GGD-94–133 (May 1994).

17. It is conventional to distinguish between exchange-traded derivatives and OTC derivatives, created as the result of bilateral negotiation between the parties to a transaction rather than by a trade on a formal exchange.

18. *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings, supra* note 10, at 250.

19. *See supra* text accompanying note 16.

20. *See* 17 Code of Federal Regulations § 240.17a-5 (1996) (requiring the filing of annual reports that are audited by an independent accountant); *Id.* § 240.17h–1T and 2T (requiring the keeping of records on risk-management policies); Derivatives Policy Group, *Framework for Voluntary Oversight* (March 1995).

21. Securities and Exchange Commission, *OTC Derivatives Oversight Statement of the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Securities and Investments Board*, International Series Release No. 642 (March 15, 1994); *see generally* Louis Loss and Joel Seligman, *Securities Regulation* 712–719 (3d ed. Supp. 1996).

22. *See herein* Ernest T. Patrikis and Douglas J. Landy, *Derivatives Activities of Banking Insitutions: Initiatives for Supervision and Enhanced Disclosure* (Chapter 16).

23. Office of the Comptroller of the Currency, *OCC 96–25: Fiduciary Risk Management of Derivatives* (May 2, 1996); *News Release 96–52: National Banks Cautioned on Derivatives in Fiduciary Accounts* (May 2, 1996); *see herein* Douglas E. Harris, *Comment* (to Chapter 16).

24. *See herein* Jimmy F. Barton, *Supervision by Risk* (Chapter 10A).

25. *See, e.g.*, The Futures and Options Association, *Managing Derivatives Risk: Guidelines for End-Users of Derivatives* (January 1996).

26. Peter Clark, *Baring All: Derivatives Markets and Their Integrity in the 1990s*, ASC Digest, Speech 12 (October 15, 1995) (address to the Asian Securities Analysts Council, 17th Annual Conference, Auckland, New Zealand, October 15–18, 1995).

27. Representatives of Regulatory Bodies from 16 Countries Responsible for Supervising the Activities of the World's Major Futures and Options Markets, Windsor Declaration (May 16–17, 1995).

28. *See* Commodity Futures Trading Commission and Securities and Investment Board, *SIB and CFTC Chairmen Welcome Windsor Declaration,* Press Release 3845–95 (May 17, 1995).

29. *See Schapiro Sounds Warning that CFTC Has Begun Policing Internal Controls,* BNA Management Briefing (October 20, 1995).

30. *See generally* Commodity Futures Trading Commission, *Six Additional Countries Sign Declaration on Cooperation and Supervision Covering International Futures Market,* Press Release 4003–97 (March 12, 1997) (listing 14 original signatories of the declaration and those signing on the one-year anniversary of the declaration).

31. *See id.*

32. *Id.*

33. *See* Basle Committee on Banking Supervision, *Basle Capital Accord: Treatment of Potential Exposure for Off-Balance-Sheet Items* (April 1995). The text of this amendment is reprinted in 4 *Current Legal Issues Affecting Central Banks*, *supra* note 5, at 799.

34. Basle Committee on Banking Supervision, *Amendment to the Capital Accord to Incorporate Market Risks* (January 1996); *see Overview of the Amendment to the Capital Accord to Incorporate Market Risks* (January 1996); *Supervisory Framework for the Use of "Backtesting" in Conjunction with the Internal Models Approach to Market Risk Capital Requirements* (January 1996).

35. *See* Institute of International Finance, *Report of the Working Group on Capital Adequacy* (July 1995).

36. Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries, *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* 26 (November 1990), *reprinted in part in* 4 *Current Legal Issues Affecting Central Banks, supra* note 5, at 797.

37. *Id.; see* EC Directive of 21 March 1996 amending Directive 89/647 as Regards Recognition of Contractual Netting by the Competent Authorities.

38. *Basle Capital Accord: Treatment of Potential Exposure for Off-Balance-Sheet Items, supra* note 33.

39. Basle Committee on Banking Supervision, *Interpretation of the Capital Accord for the Multilateral Netting of Forward Value Foreign Exchange Transactions* (April 1996).

40. 12 U.S.C. § 1821(n) (1994).

41. Although Chapter 11 of the U.S. bankruptcy code does not apply to banks, it is the classic example of such rehabilitation procedure. 11 U.S.C. §§ 109(b)(2) and (d), 1101 *et seq.* (1994).

42. Thomas Glaessner and Ignacio Mas, *Incentives and the Resolution of Bank Distress,* 10 World Bank Research Observer 53, 62 (February 1995).

43. *See* Philip Wood, *Principles of International Insolvency* paragraph 1–62 at 33 (1995).

Chapter **10A,** "Supervision by Risk" (Barton)

1. The following publications of the Office of the Comptroller of the Currency describe the Supervision by Risk program: *The Community Bank Risk Assessment* (1996); *The Bank Supervision Process* (1996); *Large Bank Supervision* (1995); and *Community Bank Procedures for Noncomplex Banks* (1994).

2. *See id.*

3. *See* Justin Fox, *Camel by Some Other Name to Focus More on Risk,* American Banker, February 23, 1996, at 1.

Chapter **10B,** "Effective Tools for the Host Country Supervisor" (Hoffman)

1. *See* 12 Code of Federal Regulations part 211 (1997).

2. Basle Committee on Banking Supervision, *Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments, in Report on International Developments in Banking Supervision* 11 (Report number 8, September

1992), *reprinted in* 3 *Current Legal Issues Affecting Central Banks* 301 (Robert C. Effros ed., 1995); *see also* Basle Committee on Banking Supervision, *Principles for the Supervision of Banks' Foreign Establishments* (May 1983) (the Basle Concordat); *Supplement to the Concordat* (April 1990). Both the Concordat and Supplement are reprinted in 1 *Current Legal Issues Affecting Central Banks* 475 (Robert C. Effros ed., 1992).

Chapter **11**, "Sharing of Information Between Supervisory Authorities" (Mattingly)

1. Basle Committee on Banking Supervision, *Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments* (June 1992), *reprinted in* 3 *Current Legal Issues Affecting Central Banks* 301 (Robert C. Effros ed., 1995).
2. *See* Thomas Baxter and Jet Joseph de Saram, *BCCI: The Lessons for Banking Supervision,* 4 *Current Legal Issues Affecting Central Banks* 371 (Robert C. Effros ed., 1997).
3. Public Law No. 102–242, §§ 201–215, 105 Stat. 2236, 2286–2305 (1991) (codified at 12 U.S.C. §§ 3101 *et seq.* (1994)).
4. *Id.*
5. 12 C.F.R. § 211.24(c)(2)(iv) (1997).
6. For a discussion of the Daiwa case, *see* M. MacDougall, *Daiwa: A Message for Foreign Banks in the United States*, 11 Butterworths Journal of International Banking and Financial Law 51 (1996).
7. *Id.*
8. *See* Board of Banking Supervision, *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings* (July 18, 1995).
9. *See* Commodities Futures Trading Commission, *Six Additional Countries Sign Declaration on Cooperation and Supervision Covering International Futures Markets*, Press Release 4003–97 (March 12, 1997).
10. Basle Committee on Banking Supervision, *Supervision of Banks' Foreign Establishments* (September 1975, revised May 1983, and supplemented April 1990), *reprinted in* 1 *Current Legal Issues Affecting Central Banks* 475 (Robert C. Effros ed., 1992). The Basle Committee on Banking Supervision, formerly known as the Committee on Banking Regulations and Supervisory Practices, was inaugurated in 1975 under the auspices of the Bank for International Settlements.
11. *Id.* at Supplement.
12. *Id.*
13. *Id.* at part B, recommendation (ii).
14. *Id.* at part D, recommendation (iii).
15. *See herein* Philip R. Wood, *International Law of Bank Secrecy* (Chapter 17).
16. The Trade Secrets Act, 18 U.S.C. § 1905 (1994, as amended 1996). Section 1905 provides:

> Whoever, being an officer or employee of the United States or of any department or agency thereof, any person acting on behalf of the Office of Federal Housing Enterprise Oversight, or agent of the Department of Justice as defined in the Antitrust Civil Process Act (15 U.S.C. 1311–1314), publishes, divulges, discloses, or makes known in any manner or to any extent not authorized by law any information coming to him in the course of his employment or official duties or by reason of any examination or investigation made by, or return, report or record made to or filed with, such department or agency or officer or employee thereof, which information concerns or relates to the trade secrets, processes, operations, style of work, or apparatus, or to the identity, confidential statistical data, amount or source of any income, profits, losses, or expenditures of any person, firm, partnership, corporation, or associa-

tion; or permits any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; shall be fined under this title, or imprisoned not more than one year, or both; and shall be removed from office or employment.

17. *Id.*

18. *See, e.g., Chrysler Corp. v. Brown*, 441 U.S. 281 (1979); *Jackson v. First Federal Savings of Arkansas*, 709 F. Supp. 887 (E.D. Ark. 1989); *Shell Oil Co. v. Dept of Energy*, 477 F. Supp. 413 (D. Del. 1979); *Emerson Elec. Co. v. Schlesinger*, 609 F. 2d 898 (8th Cir. 1979).

19. *See, e.g., Chrysler Corp. v. Brown*, 441 U.S. 281 (1979).

20. *See supra* note 16.

21. 12 U.S.C. §§ 1818(v), 3109 (1994).

22. *Id.* § 3109.

23. *Id.* § 1818(v).

24. *See, e.g., id.* §§ 326, 1442, 1817(a)(2), 1821, 2906; 15 U.S.C. §§ 78(q)(c)(3), 1691e(g) (1994).

25. Public Law No. 95–630, 92 Stat. 3641 (1978) (codified as amended at 12 U.S.C. §§ 3401–22 (1994)).

26. *See supra* note 16.

27. 12 U.S.C. §§ 3401(4) and (5), 3402 (1994).

28. *Id.* § 3402.

29. *Id.* § 3412(a).

30. *Id.* § 3412(b).

31. *Id.* § 3413(b).

32. *Id.* § 3412(e).

33. For a discussion of the common law of financial privacy in the United States, *see* C. Todd Jones, *Compulsion Over Comity: The United States' Assault on Foreign Bank Secrecy*, 12 Northwestern Journal of International Law and Business 454 (1992); Peter W. Schroth, *Bank Confidentiality and the War on Money Laundering in the United States*, 42 American Journal of Comparative Law 369 (1994).

34. 5 U.S.C. § 552a (1994).

35. *Id.* § 552a(b).

36. *Id.* § 552.

37. *Id.* § 552(a).

38. *Id.* § 552(b).

39. *Id.*

40. The disclosure requirement does not apply to "trade secrets and commercial or financial information obtained from a person and privileged or confidential" or to matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulations and supervision of financial institutions. 5 U.S.C. § 552 (b)(4) and (8) (1994).

41. *Id.* § 552(b)(6).

42. 12 U.S.C. § 3109 (1994). Section 3109 provides:

(a) Disclosure of supervisory information to foreign supervisors. Notwithstanding any other provision of law, the Board, Comptroller of the Currency, Federal Deposit Insurance Corporation, and Director of the Office of Thrift Supervision may disclose information obtained in the course of exercising supervisory or examination authority to any foreign bank regulatory or supervisory authority if the Board, Comptroller, Corporation, or Director determines that such disclosure is appropriate and will not prejudice the interests of the United States.

(b) Requirement of confidentiality. Before making any disclosure of any information to a foreign authority, the Board, Comptroller of the Currency, Federal Deposit Insurance Corporation, and Director of the Office of Thrift Supervision shall obtain, to the extent necessary, the agreement of such foreign authority to maintain the confidentiality of such information to the extent possible under applicable law.

43. *Id.* § 3109(a).
44. *Id.* § 3109(b).
45. *Id.* § 3109(a).
46. *Id.*
47. *Id.* § 1818(v). Section 1818(v) provides:

Foreign investigations

(1) Requesting assistance from foreign banking authorities. In conducting any investigation, examination, or enforcement action under this chapter, the appropriate Federal banking agency may—

(A) request the assistance of any foreign banking authority; and

(B) maintain an office outside the United States.

(2) Providing assistance to foreign banking authorities.

(A) In general. Any appropriate Federal banking agency may, at the request of any foreign banking authority, assist such authority if such authority states that the requesting authority is conducting an investigation to determine whether any person has violated, is violating, or is about to violate any law or regulation relating to banking matters or currency transactions administered or enforced by the requesting authority.

(B) Investigation by Federal banking agency. Any appropriate Federal banking agency may, in such agency's discretion, investigate and collect information and evidence pertinent to a request for assistance under subparagraph (A). Any such investigation shall comply with the laws of the United States and the policies and procedures of the appropriate Federal banking agency.

(C) Factors to consider. In deciding whether to provide assistance under this paragraph, the appropriate Federal banking agency shall consider—

(i) whether the requesting authority has agreed to provide reciprocal assistance with respect to banking matters within the jurisdiction of any appropriate Federal banking agency; and

(ii) whether compliance with the request would prejudice the public interest of the United States.

(D) Treatment of foreign banking authority. For purposes of any Federal law or appropriate Federal banking agency regulation relating to the collection or transfer of information by any appropriate Federal banking agency, the foreign banking authority shall be treated as another appropriate Federal banking agency.

(3) Rule of construction. Paragraphs (1) and (2) shall not be construed to limit the authority of an appropriate Federal banking agency or any other Federal agency to

provide or receive assistance or information to or from any foreign authority with respect to any matter

48. *Id.* § 1818(v)(2)(C).

49. 5 U.S.C. § 552(a) (1994).

50. 12 U.S.C. § 1831 (1994).

51. *Id.* § 3109.

52. *Id.* § 3109(b).

53. Letter from Richard Spillenkothen, Director of the Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, and Susan F. Krause, Senior Deputy Comptroller for Bank Supervision Policy, Office of the Comptroller of the Currency, to Jochen Sanio, Departmental President, Bundesaufsichtsamt für das Kreditwesen (February 17, 1994); Letter from Jochen Sanio, Departmental President, Bundesaufsichtsamt für das Kreditwesen to Richard Spillenkothen, Director of the Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, and Susan F. Krause, Senior Deputy Comptroller for Bank Supervision Policy, Office of the Comptroller of the Currency (February 17, 1994).

54. Letter from the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the New York States Banking Department to the Securities and Investments Board (undated) (subsequent correspondence indicates that the letter was received by the Securities and Investments Board on December 19, 1988).

Chapter **11**, Comment (O'Day)

1. Nevertheless, the *Report of the Board of Banking Supervision Inquiry Into the Circumstances of the Collapse of Barings* has noted:

> The Bank [of England] has had frequent formal and informal contacts with the Singaporean and Japanese regulatory authorities in recent years, including visits by Sergeant and Quinn to the MAS in Singapore in March 1994 and January 1995 respectively to discuss supervisory issues. In these contacts Barings was either not mentioned, or only mentioned in passing. The Bank has told us that at no time prior to the collapse were any warnings given to the Bank by Singaporean or Japanese regulatory authorities regarding potential dangers faced by any Barings Group companies or about the systems and controls in those companies.

Board of Banking Supervision, *Report of the Board of Banking Supervision Inquiry Into the Circumstances of the Collapse of Barings* paragraph 12.103 at 216–217 (July 18, 1995).

2. Foreign Bank Supervision Enhancement Act of 1991 § 202, 12 U.S.C. § 3105(d)(2)(A) (1994).

3. *Id.* § 3105(d)(3)(c).

Afterword to Chapters **10** and **11** (Blair)

1. *See, e.g.,* Andrea M. Corcoran, *Prudential Regulation of OTC Derivatives: Lessons from the Exchange-Traded Sector, in Prudential Regulation of Banks and Securities Firms* Chapter 11 (Guido Ferrarini ed., 1995).

2. Basle Committee on Banking Supervision, *The Ensuring of Adequate Information Flows between Banking Supervisory Authorities* (April 1990).

3. CAMEL is an acronym for capital, asset quality, management, earnings, and liquidity.

4. Basle Committee on Banking Supervision, *Amendment to Capital Accord to Incorporate Market Risks* (January 1996); *see generally* Hal S. Scott, *Models-Based Regulation of Bank Capital, in* R. Cranston, *Making Commercial Law: Essays for Roy Goode* (forthcoming).

5. For a description of the system, *see* Edward L. Symons, Jr., *The United States Context, in International Banking Regulation and Supervision: Change and Transformation in the 1990s* at 1 (Joseph J. Norton *et al.* eds., 1994).

6. First Council Directive 77/780 of 12 December 1977 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, Art. 12, 1977 O.J. (L 322) 30 (amended in 1985, 1986, and 1989), *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 251 (Robert C. Effros ed., 1994).

7. *Id.* Art. 12(2).

8. Board of Banking Supervision, Bank of England, *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings* (July 18, 1995).

9. *Id.* at 119 *et seq.*

10. For an excellent commentary on the Bank, *see* Christos Hadjiemmanuil, *Banking Regulation and the Bank of England* (1996).

11. If the linkage between an authorised institution and one of its subsidiaries is sufficiently strong, and certain other criteria (in particular, as regards the relative sizes of the institution and the subsidiary in question) are met, the Bank may permit the subsidiary to be treated as effectively a division of the institution and included in the institution's unconsolidated prudential returns filed with the Bank. This is known as 'solo consolidation'. Where this occurs the subsidiary is monitored for capital adequacy and large exposure reporting purposes as if it were part of the institution. The requirements for a bank subsidiary to be solo consolidated with the parent bank are set out in a Bank Notice issued in 1993 and include requirements that management of the solo consolidated subsidiary must be under the 'effective supervision' of the parent bank and that there should be no obstacle to the payment of surplus capital up to the parent bank. The intention is that the subsidiary should be sufficiently closely linked to the parent bank that it is treated as one with the bank. The intended effect of the requirements is that the linkage between the subsidiary and the bank should be such that it should be possible to wind up the subsidiary rapidly and repatriate the capital to support depositors with the bank.

Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings, supra note 8, paragraph 12.9 at 193.

12. *Id.* at 257–263.

13. Bank of England, *The Bank's Review of Supervision* 1 *et seq.* (July 24, 1996).

14. Described by the acronym RATE (risk assessment, tools of supervision, and evaluation).

15. *See* Donald T. Brash, *Banking Supervision: New Zealand Adopts a New Approach,* 48 [Consumer Finance Law] Quarterly Report 298 (1994).

Chapter **12,** "Resolution of Sovereign Liquidity Crises: Basic Concepts and Issues" (Gianviti)

1. 11 U.S.C. §§ 109(c)(1), 901 *et seq.* (1994).

2. *Id.* § 303(a) (1994).

3. On the legal and economic definitions and characteristics of a country's external debt, *see* F. Gianviti, *The International Monetary Fund and External Debt, Recueil des cours de l'Académie de droit international,* vol. 215 (1989-III), p. 207, at pp. 232–237.

Chapter **13,** "Legal Framework for Dealing with Sovereign Debt Defaults" (Morais)

1. There are a few other subsidiary categories of sovereign debt such as short-term debt (usually having a term of 12 months or less); interbank deposits; trade debt, such as sup-

pliers' credits and letters of credit; and domestic-currency-denominated debt. Such debts have normally been excluded from sovereign debt reschedulings.

2. In most instances, a sovereign creditor would not institute legal process against a sovereign borrower. However, a sovereign creditor may press its claims in other ways, including through diplomatic means, by reducing or freezing bilateral assistance, or by imposing economic sanctions. It may also assign the loan to a third party, who might then take legal action.

3. The provision for termination and acceleration usually states that, if any of the enumerated events of default occurs and continues for a specified period of time (for example, 90 days), then the lenders may take action to terminate the lending commitment and accelerate the loan by a decision of lenders holding a specified minimum percentage (typically 50 percent or 66⅔ percent) of the total commitments or advances.

4. 11 U.S.C. § 945(a) (1994).

5. *Id.* § 945(b).

6. *Id.* § 350(b).

Chapter **14**, "Legal Remedies in the Event of a Sovereign Debt Default" (Gordon and Milenkovich)

1. As this paper was presented by Richard K. Gordon, only his biography appears in the biographical sketches.

2. The Group of Ten is composed of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

3. Since this paper was presented, foreign exchange crises in Thailand, Malaysia, the Phillippines, and Indonesia have underscored these concerns.

4. "[G]overnment borrowing . . . usually implies future taxation to service the debt. It is therefore a device to substitute future taxation for current taxation." Carl S. Shoup, *Public Finance* 441 (1969).

5. For example, the Federal Savings and Loan Insurance Corporation's debt was not subject to the legal guarantee of the United States. Nevertheless, the U.S. government felt compelled to ensure that it did not fail, resulting in a huge taxpayer's bailout following the collapse of many savings and loan financial institutions in the 1980s. What would happen if the Federal National Mortgage Association (Fannie Mae), one of the largest borrowers in the world, were to fail is anyone's guess.

6. It also means that a bankruptcy proceeding cannot be used to enforce an equitable distribution of a sovereign's attachable assets among its creditors. The unavailability of the enforced sharing of available assets by unsecured creditors found in bankruptcy laws has a profound affect on a sovereign issuer's ability to negotiate refinancing agreements with its bondholders. It may encourage creditors, especially those with a relatively smaller exposure, to rush to court, sue, receive a judgment, and attach assets before anyone else does. This issue has become increasingly important as securitized debt has replaced syndicated loans, whose agreements generally include contractual sharing clauses.

7. This raises the question of debt, such as the Mexican tesobonos, which were denominated in pesos but which included a contractual right to convert the currency into dollars at a fixed rate of exchange. In economic terms, these instruments are nearly the same as foreign-exchange-denominated debt. In addition, a default of the sovereign will give rise to a foreign exchange claim by the creditor and sovereign immunity protection by the borrower. However, these instruments do not typically include clauses providing for consent to the jurisdiction of foreign courts or for waiver of sovereign immunity. Therefore, they are legally distinct from most other foreign-exchange-denominated debt with regard to issues of legal redress in time of default. *See* Tesobono Offering Circular (1993).

8. *See, for example,* Jeffrey Sachs, *Do We Need an International Lender of Last Resort?* Lecture at Princeton University (April 20, 1995) (on file with the authors); Jim Leach, *Country Going Bankrupt? Call the IMF*, Wall Street Journal, April 10, 1995, at A23.

9. This would include short-term trade debt, other short-term loans, letters of credit, etc.

10. There is a recent exception to this rule. It involved a loan from one central bank to another central bank. After default, the creditor assigned the loan to a private company, which then sought legal redress. *See Plenum Financial and Investment Ltd. v. Bank of Zambia*, Queen's Bench 1993, Folio No. 2051 (September 7, 1995).

11. There have been a number of instances where so-called rogue creditors have sued to recover on a sovereign default. Frequently, the creditor is not a member of the syndicate, but is the assignee of a member. *See, for example, CIBC Bank and Trust Company (Cayman) Ltd. v. Banco Central Do Brasil*, 1995 U.S. Dist. LEXIS 6268 (S.D.N.Y. May 9, 1995).

12. *See* Barry Eichengreen and Richard Portes, *Crisis, What Crisis: Orderly Workouts for Sovereign Debtors* (Center for Economic Policy Research Report, 1995).

13. An important component may include the securing of prejudgment attachment of assets to ensure that they do not leave the jurisdiction of the court.

14. This has often happened when defaulting governments have decreed legal moratoria. *See, e.g., Mayer v. Hungarian Commercial Bank of Pest*, 21 F. Supp. 144 (E.D.N.Y. 1937); *National Bank of Greece and Athens v. Metliss*, 1958 Appeal Cases 509 (U.K.).

15. For instance, courts in France will find personal jurisdiction based on the citizenship or residence of the plaintiff. Civil Code, Art. 14; *see* Andrew L. Strauss, *Beyond National Law: The Neglected Role of the International Law of Personal Jurisdiction in Domestic Courts,* 36 Harvard International Law Journal 388 (1995). Courts in New York will find jurisdiction based on the presence of a paying agent in the forum country. *See, for example, Republic of Argentina and Banco Central de la Republica Argentina v. Weltover, Inc.*, 504 U.S. 607 (1992).

16. Numerous other defenses have been raised by defaulting sovereigns sued by creditors. However, those defenses have rarely, if ever, been successful.

17. For example, the Treaty of Friendship, Commerce, and Navigation between the United States and Japan states:

> No enterprise of either Party, including . . . government agencies and instrumentalities, which is publicly owned or controlled shall, if it engages in commercial . . . or other business activities within the territories of the other Party, claim or enjoy, either for itself or for its property, immunity therein from taxation, suit, execution of judgment or other liability to which privately owned and controlled enterprises are subject therein.

Treaty of Friendship, Commerce, and Navigation between the United States and Japan, April 2, 1953, art. 18(2), 4 U.S.T. 2063, 2077.

18. *See* Foreign Sovereign Immunities Act, 28 U.S.C. § 1602 *et seq.* (1995) (*hereinafter* FSIA) (enacted in 1976) (U.S.); State Immunity Act, 1978, Chapter 33 (*hereinafter* SIA) (U.K.).

19. SIA § 3(3)(b).

20. *See* FSIA § 1605(a)(2).

21. The U.S. and U.K. laws each include provisions concerning waivers of sovereign immunity. The U.S. FSIA states that once a foreign country waives immunity, it "has waived its immunity . . . notwithstanding any withdrawal of the waiver which the foreign state may purport to effect." FSIA § 1605(a)(1). The SIA has a similar provision. *See* SIA § 2(1). For the rule in Japan, *see* Kazuya Hirobe, *Immunity of State Property: Japanese Practice,* 10 Netherlands Yearbook of International Law 233, 234 (1979).

22. Recognition of Foreign Country Money Judgments, New York Civil Practice Law and Rules §§ 5301–5309 (McKinney's 1978).

23. *Id.* §§ 5302–5304. The Recognition of Foreign Country Money Judgments Act also applies to judgments that are pending or are subject to appeal. *Id.* § 5302. A court, however, may stay proceedings until an appeal has been decided if the defendant satisfies the court that the appeal is pending or that he intends to appeal from the judgment. *Id.* § 5306. A foreign judgment will not be recognized if the foreign proceedings were not fair and impartial and did not comport with due process of the law, or if the foreign court did not have personal jurisdiction over the judgment debtor. *Id.* § 5304(a). A court, in its discretion, may also not recognize the judgment if the foreign court did not have subject matter jurisdiction, the defendant received insufficient notice of the proceedings, the judgment was obtained by fraud, the underlying cause of action is repugnant to the public policy of New York, the judgment conflicts with another final judgment, the proceeding in the foreign court was contrary to the parties' agreed upon method of dispute resolution, or the forum was seriously inconvenient. *Id.* § 5304(b).

24. 1983 Official Journal of the European Communities (C 97) 1.

25. *See, for example*, Code of Civil Procedure, Art. 200 (Japan), *reprinted in* Shinichiro Tanaka, *Japan, in Enforcement of Money Judgments Abroad* JAP–1, Appendix I (Philip R. Weems ed., 1992).

26. Such immunities are not typically subject to waiver under domestic law.

27. Some debt may be partially securitized; the nature of the security interest would determine its amenability to seizure. One of the most important types of securitized sovereign debt is Brady bonds. In the case of these bonds, the creditor cannot seize the underlying asset, a stripped U.S. treasury bond (which is typically held by a custodial bank in New York), until maturity. However, at maturity the creditor may take possession. Because of this, the present value of the security is assured to the creditor.

28. *See, e.g.,* D.C. Code § 16–501(d)(3) (1997). In the United Kingdom, courts do not have the power to order "prejudgment" attachment of assets. However, a similar result is reached with the Mareva injunction, by which the court orders the defendant not to remove assets from the court's jurisdiction.

29. FSIA § 1611(b)(2).

30. FSIA § 1610(a)(4)(B); *see* Vienna Convention on Diplomatic Relations, April 18, 1961, Art. 22(3), 500 U.N.T.S. 95 [hereinafter Vienna Convention] (regarding the property of missions). The United States is a party to the Vienna Convention.

31. *See* SIA § 16(1). The United Kingdom is also a party to the Vienna Convention.

32. Section 16(2) of the SIA states: "This Part of this Act does not apply to proceedings relating to anything done by or in relation to the armed forces of a State while present in the United Kingdom . . . ."

33. This would generally include diplomatic missions, military property, etc. *See generally* James Crawford, *Execution of Judgments and Foreign Sovereign Immunity*, 75 American Journal International Law 820, 837–843 (1981); Georges R. Delaume, *Immunity From Execution of Foreign States and International Organizations, in* 2 *Transnational Contracts* § 12.03 (1990).

34. 729 F. Supp. 936 (S.D.N.Y. 1989).

35. *Id.* at 944.

36. Most commercial loan agreements contain provisions that give a lender the right to cancel the loan or suspend disbursements in the event of changed circumstances.

37. *See De Letelier v. Republic of Chile*, 748 F.2d 790 (2d Cir. 1984); *see also Hercaire Int'l, Inc. v. Argentina*, 821 F.2d 559 (11th Cir. 1987) (providing that assets of Argentina's wholly owned national airline were not subject to execution to satisfy a judgment against Argentina where the airline was neither a party to the suit nor was connected with the underlying transaction giving rise to the suit).

38. George Weisz *et al.*, *Selected Issues in Sovereign Debt Litigation, in Latin American Sovereign Debt Management* 230, 267 (Ralph Reisner *et al.* eds., 1990) (quoting the U.S.

Supreme Court in *First National City Bank v. Banco Para El Comercio Exterior de Cuba,* 462 U.S. 611, 629–630 (1983)).

39. *See First National City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611 (1983). The plaintiff was a state-owned bank, which sought to collect on a letter of credit issued by an American bank shortly before all of the American bank's assets in Cuba were nationalized by the Cuban government. When the Cuban bank brought suit in the United States, the American bank counterclaimed, asserting a right to set off the value of its seized Cuban assets. After the suit was brought, but before the petitioner filed its counterclaim, the Cuban bank was dissolved and its capital was split between Banco Nacional, Cuba's central bank, and certain foreign trade enterprises or houses of the Cuban Ministry of Foreign Trade. Rejecting the Cuban bank's contention that its separate juridical status shielded it from liability for the acts of the Cuban government, the District Court held that, since the value of the petitioner's Cuban assets exceeded the respondent's claim, the setoff could be granted in the petitioner's favor and, therefore, dismissed the complaint. On appeal, the Supreme Court held that, while duly created instrumentalities of a foreign country are to be accorded a presumption of independent status, this presumption may be overcome where giving effect to the corporate form would permit a foreign country to be the sole beneficiary of a claim pursued in United States courts while escaping liability to the opposing party imposed by international law.

40. *See* 2 Philip Wood, *Law and Practice of International Finance* § 4.06[10] (1990).

41. In one case, attachment was not permitted on the ground that the public entity was owned not only by the sovereign, but also by foreign banks. Judgment of July 21, 1987, Cour de cassation, Première chambre civile, 115 Journal du Droit International (Clunet) 108 (1988). In another case, attachment of a foreign state-owned entity's ship to collect a debt of the foreign country was not upheld on the ground that the foreign country could claim immunity of jurisdiction for the debt. Judgment of February 4, 1986, Cour de cassation, Premère chambre civile, 1986 Revue Critique de Droit International Privé 718; *see* Judgment of November 18, 1986, Cour de cassation, Première chambre civile, 114 Journal du Droit International (Clunet) 120 (1987).

42. Judgment of July 6, 1988, Cour de cassation, Première chambre civile, 116 Journal du Droit International (Clunet) 376 (1989).

43. The U.S. Foreign Sovereign Immunities Act (FSIA) provides that property of a foreign central bank "held for its own account" is immune from execution and attachment in aid of execution, unless the bank or its parent foreign government explicitly waives such immunity. According to the U.S. Department of Justice and Department of State, funds "'held' for the [central] bank's . . . 'own account'" are "funds used or held in connection with central banking activities . . ." While an authoritative interpretation has yet to be rendered by a court, it has generally been assumed that this would include the country's general foreign exchange reserves. Only that interpretation would protect New York's position as a major repository of the foreign exchange assets of foreign central banks. "The idea is to preserve the attractiveness of London and New York as preferred places of investment for foreign central banks." Christoph H. Schreuer, *State Immunity: Some Recent Developments* 158 (1988).

44. *See, e.g.*, recent notes issued by the Central Banks of Colombia and Venezuela.

45. For example, bonds recently issued by the central banks of the Czech Republic, Hungary, Nigeria (issues in exchange for promissory notes), Romania, the Slovak Republic, and Tunisia all include comprehensive waivers.

46. FSIA § 1610(d).

47. Reasons given for the special protection of central bank assets in the FSIA, aside from their importance to their own nations, are that, without such special treatment, the deposit of foreign funds in the United States might be discouraged, and execution against the reserves of foreign countries could cause foreign relations problems. House Report No.

94–1487, 94th Congress, 2d Session 31 (1976), *reprinted in* 1976 U.S.C.C.A.N. 6604, 6630.

48. *Weston Compagnie de Finance et d'Investissement, S.A.,* 823 F. Supp. 1106, 1110 (S.D.N.Y. 1993); *see id.* at 1111 (noting that, given the disruptive effect prejudgment attachment may have as well as the possible foreign policy implications, the statute does not provide for waiver of immunity from prejudgment attachment of central bank funds held for its own account); *see also Banque Compafina v. Banco de Guatemala,* 583 F. Supp. 320 (S.D.N.Y. 1984) (holding section 1611(b) does not permit waiver from prejudgment attachment).

49. *Plenum Financial and Investments Ltd. v. Bank of Zambia,* 1995 U.S. Dist. LEXIS 14883 (S.D.N.Y. 1995).

50. *Id.* Central bank assets are not immune from setoff under the Foreign Sovereign Immunities Act. In *Banco Central de Reserva del Peru v. The Riggs National Bank of Washington, D.C.,* the court held that section 1611(b), which provides for immunity from the legal remedies of attachment and execution, does not extend to setoff, a remedy in equity. 919 F. Supp. 13 (D.D.C. 1994).

51. SIA §§ 14(4) and 13(2)(a) and (3).

52. *See Nonresident Petitioner v. Central Bank of Nigeria,* 15 International Legal Materials [I.L.M.] 501 (1977) (Germany).

53. *See Société Eurodif v. République Islamique d'Iran,* 23 I.L.M. 1062 (1984); Charles J. Lewis, *State and Diplomatic Immunity* paragraph 12.24 (3d ed. 1990)(discussing *Société Eurodif*); Delaume, *supra* note 33, § 12.03.

54. *See* Eichengreen and Portes, *supra* note 12.

Chapter **15,** "The Debt-Rescheduling Process: Pitfalls and Hazards" (Buchheit)

1. *See* Edwin M. Truman, *The Debt Crisis and Its Resolution, in 3 Current Legal Issues Affecting Central Banks* 115 (Robert C. Effros ed., 1995).

2. *See* Lee C. Buchheit and Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships,* 1988 University of Illinois Law Review 493, 508–510 (1988).

3. *See* Lee C. Buchheit, *Making Amends for Amendments,* 10 International Financial Law Review 11 (February 1991).

4. The stranglehold of these clauses was eventually broken (starting in 1987 with the restructuring agreements signed in that year by Mexico and the Philippines) through the inclusion of so-called debt-for-debt exchange provisions. Subject to certain restrictions, these clauses allowed debts to be lifted out of the restructuring agreements and exchanged for new debt instruments. Creditors unwilling to accept the exchange offer remained in the original restructuring agreement and were not entitled to share in any payments made in respect of the new debt instrument. Through this device, the payment terms of restructuring agreements could be effectively amended for those creditors electing to make the exchange without having to obtain the consent of every other creditor to the original restructuring agreement. Debt-for-debt exchange provisions thus established the legal structure for implementation of the Brady Initiative. *See* Lee C. Buchheit, *Exchanging Places,* 10 International Financial Law Review 13 (May 1991).

5. *See, e.g.,* 11 U.S.C. § 362 (1995).

6. *See id.* § 1129 (1995).

7. *See, e.g.,* New York Judiciary Law § 489 (1995).

8. *See* Lee C. Buchheit, *Banking on Immunity,* 11 International Financial Law Review 11 (February 1992).

9. U.S. Const., Art. II, § 2.

10. *Allied Bank International v. Banco Credito Agricola de Cartago,* 757 F.2d 516 (2d Cir. 1985).

11. *CIBC Bank and Trust Company (Cayman) Ltd. v. Banco Central do Brasil,* 886 F. Supp. 1105 (1995); *see* Mary Jo White, United States Attorney for the Southern District of New York, and Steven M. Haber, Assistant United States Attorney, *Statement of Interest of the United States of America in Opposition to the First Amended Complaint,* submitted in 94 Civ. 4733 (LAP).

12. *See* Lee C. Buchheit, *The Sharing Clause as a Litigation Shield,* 9 International Financial Law Review 15 (October 1990).

Afterword to Chapters **12** to **15** (Gianviti)

1. International Monetary Fund, Articles of Agreement, Art. VIII, § 2(b) (1993).
2. *Id.* Art. VI, § 3.
3. *See id.* Art. VIII, § 2(a).
4. *Id.*
5. *Restatement (Third) of the Foreign Relations Law of the United States* § 822 comment c (1987).
6. *Id.*

Foreword to Chapters **16** and **17** (Wood)

1. *See* Federal Deposit Insurance Corporation Improvement Act of 1991, Public Law No. 102–242, § 401 *et seq.,* 105 Stat. 2236, 2371 (1991).

Chapter **16,** "Derivatives Activities of Banking Institutions: Initiatives for Supervision and Enhanced Disclosure" (Patrikis and Landy)

1. The authors extend their appreciation to Christine Cumming, Senior Vice-President, for her assistance in the preparation of this chapter.

2. *Principles and Practices for Wholesale Financial Market Transactions* (undated) (released August 17, 1995), *reprinted in* 4 *Current Legal Issues Affecting Central Banks* 786 (Robert C. Effros, ed., 1997).

3. Board of Governors of the Federal Reserve System, *Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations,* SR 93-69 (FIS) (December 20, 1993) [hereinafter *Trading Activities Examiner Guidelines*].

4. Board of Governors of the Federal Reserve System, *Trading Activities Manual* (looseleaf).

5. Board of Governors of the Federal Reserve System, *Evaluating the Risk Management and Internal Controls of Securities and Derivatives Contracts Used in Nontrading Activities,* SR 95-17 (SUP) (March 28, 1995).

6. Board of Governors of the Federal Reserve System, *Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies,* SR 95-51 (SUP) (November 14, 1995).

7. Written agreement by and among Bankers Trust New York Corporation, Bankers Trust Company, BT Securities Corporation, and the Federal Reserve Bank of New York (December 4, 1994 and, as amended, July 18, 1995).

8. *See infra* the text accompanying note 8.

9. *Trading Activities Examiner Guidelines, supra* note 3, at 13.

10. *Id.*

11. Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries, Bank for International Settlements, *The Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* (November 1990). An excerpt setting forth the "Minimum standards for the design and operation of cross-border and multi-currency netting and settlement schemes" is reprinted in 4 *Current Legal Issues Affecting Central Banks, supra* note 2, at 797.

12. 12 Code of Federal Regulations part 208, Appendix A (1996).

13. *Id.* part 225, Appendix A.

14. *See* Ernest T. Patrikis, First Vice-President of the Federal Reserve Bank of New York, *Price Transparency — A quote is a quote is a. . . .* , Address at the Financial Markets Conference (February 24, 1996) (providing valuable guidance on the use of valuation techniques in risk management).

15. The acronym CAMEL refers to the five elements of the Uniform Financial Institutions Rating System: (i) capital; (ii) asset quality; (iii) management; (iv) earnings; and (v) liquidity.

16. Risk-Based Capital Standards: Interest Rate Risk, 60 Federal Register [Fed. Reg.] 39490 (August 2, 1995) (effective September 1, 1995).

17. 12 Code of Federal Regulations part 208, Appendix A.

18. Federal Deposit Insurance Corporation Improvement Act § 305(b), 12 U.S.C. § 1828 note (1994).

19. Risk-Based Capital Standards: Interest Rate Risk, *supra* note 14.

20. Risk-Based Capital Standards: Market Risk, 60 Fed. Reg. 38082 (July 25, 1995).

21. *Id.*

22. *See infra* the text accompanying note 73.

23. Risk-Based Capital Standards; Market Risk; Internal Models Backtesting, 61 Fed. Reg. 9114 (March 7, 1996).

24. Basle Committee on Banking Supervision, *Supervisory Framework for the Use of "Backtesting" in Conjunction with the Internal Models Approach to Market Risk Capital Requirements* (January 1996); *see also Amendment to the Capital Accord to Incorporate Market Risks* (January 1996); *Overview of the Amendment to the Capital Accord to Incorporate Market Risks* (January 1996).

25. *See Supervisory Framework for the Use of "Backtesting" in Conjunction with the Internal Models Approach to Market Risk Capital Requirements, supra* note 24.

26. 12 Code of Federal Regulations part 208, Appendix A.

27. *Id.* part 225, Appendix A.

28. Risk-Based Capital Standards: Derivative Transactions, 60 Fed. Reg. 46169 (September 5, 1995).

29. *Id.* at 46177.

30. *Id.* at 46169 *et seq.*

31. Basle Committee on Banking Supervision, *Basle Capital Accord: Treatment of Potential Exposure for Off-Balance-Sheet Items* (April 1995). The text of this amendment is reprinted in 4 *Current Legal Issues Affecting Central Banks, supra* note 2, at 799.

32. *See* Capital; Capital Adequacy, 59 Fed. Reg. 62987 (December 7, 1994) (effective December 31, 1994).

33. Basle Committee on Banking Supervision, *Basle Capital Accord: The Treatment of the Credit Risk Associated with Certain Off-Balance-Sheet Items* (July 1994). This change, which was incorporated into a 1995 amendment of the Basle Capital Accord, is reprinted in 4 *Current Legal Issues Affecting Central Banks, supra* note 2, at 799.

34. 12 Code of Federal Regulations part 231 (1996).

35. 12 U.S.C. §§ 4401–4407 (1994).

36. *Id.* §§ 4402(9), 4403.

37. *See* 12 Code of Federal Regulations § 231.1 *et seq.* (1996).

38. *See* Netting Eligibility for Financial Institutions, 61 Fed. Reg. 1273, 1274 (January 19, 1996).

39. Letter from Oliver Ireland, Associate General Counsel, Board of Governors of the Federal Reserve System (August 22, 1994).

40. 12 Code of Federal Regulations §§ 217.1(c), 217.3 (1996).

41. *Id.* § 217.2(d).

42. Office of the Comptroller of the Currency [OCC], *Banking Circular No. 277: Risk Management of Financial Derivatives* (October 27, 1993), *reprinted in part in* 4 *Current Legal Issues Affecting Central Banks, supra* note 2, at 780.

43. *See The Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries, supra* note 11.

44. OCC, *OCC Bulletin 94-31: Questions and Answers RE: BC-277: Risk Management of Financial Derivatives* (May 10, 1994).

45. OCC, *OCC Advisory Letter 95-1: Interest Rate Risk* (February 8, 1995).

46. *Id.*

47. OCC, *OCC 95-28: Questions and Answers for Advisory Letter 95-1: Interest Rate Risk* (June 20, 1995).

48. OCC, *Review of the Sales Practices of the Largest National Bank Derivatives Dealers* (June 7, 1995).

49. *OCC, Risk Management of Capital Derivatives: Comptroller's Handbook* (October 1994).

50. OCC, *News Release 95-101: OCC Launches Supervision By Risk Program* (September 26, 1995); *see herein* Jimmy F. Barton, *Supervision by Risk* (Chapter 10A).

51. OCC, *Community Bank Examination Procedures for Noncomplex Banks: Comptroller's Handbook* (October 1995).

52. OCC, *Large Bank Supervision: Comptroller's Handbook* (December 1995).

53. OCC, *Futures Commission Merchant Activities* (November 1995); *see News Release 95–122: Derivatives Guidance for FCM Activities* (November 9, 1995).

54. *News Release 95–13: Emerging Market Country Products and Trading Activities* (December 20, 1995).

55. OCC, *Emerging Market Country Products and Trading Activities: Comptroller's Handbook* (December 1995).

56. Stanley J. Poling, Division of Supervision, Federal Deposit Insurance Corporation, *Examination Guidance for Financial Derivatives*, FIL-34-94 (May 18, 1994).

57. *Principles and Practices for Wholesale Financial Market Transactions, supra* note 2.

58. Derivatives Policy Group, *Framework for Voluntary Oversight* (March 1995).

59. *Id.* at 37.

60. *See infra* the text accompanying note 82.

61. Proposed Amendments to Require Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Qualitative and Quantitative Information About Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments, 61 Fed. Reg. 578 (January 8, 1996).

62. *See* Disclosure of Off-Balance-Sheet Derivatives, 59 Fed. Reg. 11071 (March 9, 1994).

The President of the Federal Reserve Bank of New York, William McDonough, has noted that effective risk management also requires increased financial disclosures and market transparency. William McDonough, Remarks at the Philadelphia Stock Exchange's International Currency Options Symposium (November 2, 1994). The speech also provides valuable insights on market risks posed by new financial products and the effectiveness of traditional safeguards against systemic risk. *Id.*

63. *See* Agency Forms Under Review; Bank Holding Company Reporting Requirements, 60 Fed. Reg. 16473 (March 30, 1995).

64. *See* Federal Financial Institutions Examination Council, *Important Notice: Call Report Changes* (undated, released in December 1995) (reviewing Call Report Changes (March 31, 1996) for FFIEC 031–034).

65. *See* 12 Code of Federal Regulations § 325.2(t) and part 325, Appendix A (1997) (defining Tier 1 capital (core capital) and Tier 2 capital (supplementary capital)).

66. Basle Committee on Banking Supervision, *Risk Management Guidelines for Derivatives* (July 1994), *reprinted in part in* 4 *Current Legal Issues Affecting Central Banks, supra* note 2, at 772; Technical Committee, International Organization of Securities Commissions, *Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms* (July 1994).

67. *Risk Management Guidelines for Derivatives, supra* note 66, at 4.

68. Working Group of the Eurocurrency Standing Committee of the Central Banks of the Group of Ten Countries, *A Discussion Paper on Public Disclosure of Market and Credit Risks by Financial Intermediaries* 1 (September 1994).

69. *Id.*

70. *Id.* at 2, 7.

71. Federal Reserve Bank of New York, *Public Disclosure of Risks Related to Market Activity* (November 1994).

72. *Id.* at 1–3, 12 *et seq.*

73. Basle Committee on Banking Supervision, *Proposal to Issue a Supplement to the Basle Capital Accord to Cover Market Risks* (April 1995); *Planned Supplement to the Capital Accord to Incorporate Market Risks* (April 1995).

74. *Planned Supplement to the Capital Accord to Incorporate Market Risks, supra* note 73 at 5.

75. Basle Committee on Banking Supervision, *Amendment to the Capital Accord to Incorporate Market Risks* (January 1996); *see Overview of the Amendment to the Capital Accord to Incorporate Market Risks* (January 1996); *see also Supervisory Framework for the Use of "Backtesting" in Conjunction with the Internal Models Approach to Market Risk Capital Requirements, supra* note 24.

76. *Amendment to the Capital Accord to Incorporate Market Risks, supra* note 75, at 39–41.

77. *Id.* at 44–45.

78. *Id.* at 44.

79. *Supervisory Framework for the Use of "Backtesting" in Conjunction with the Internal Models Approach to Market Risk Capital Requirements, supra* note 24.

80. *See* Risk-Based Capital Standards; Market Risk; Internal Models Backtesting, *supra* note 23, and accompanying text.

81. Basle Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissions, *Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms* (May 1995), *reprinted in part in* 4 *Current Legal Issues Affecting Central Banks, supra* note 2, at 760.

82. Basle Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissions, *Public Disclosure of the Trading and Derivatives Activities of Banks and Securities Firms* (November 1995).

83. *Id.* at 2.

84. *See Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms, supra* note 81.

85. U.S. Government Accounting Office, *Financial Derivatives: Actions Needed to Protect the Financial System,* GAO.GGD-94–133 (May 18, 1994).

86. *See* FDICIA, *supra* note 18, § 112, 12 U.S.C. § 1831m (1994).

87. U.S. Government Accounting Office, *supra* note 85, at 14.

88. Bankruptcy Reform Act of 1994 § 215, 11 U.S.C. § 101(53B)(A) (1994 and Supp. I 1995).

89. *See* House Report No. 103-835, 103d Congress, 2d Session 49 (1994).

90. Working Group on Financial Markets, *Report of the Secretary of the Treasury, Chair, President's Working Group on Financial Markets on Financial Market Coordination and Regulatory Activities to Reduce Risks in the Financial System in 1993 and 1994* (October 1994).

Chapter 16, Comment (Asser)

1. The requirement to pay margin implies that the market has moved against the position so much that the position should be closed.

2. The nine categories of risk are credit risk, interest rate risk, liquidity risk, price risk, foreign exchange risk, transaction risk, compliance risk, strategic risk, and reputation risk.

3. Basle Committee on Banking Supervision, *Amendment to the Capital Accord to Incorporate Market Risks* (January 1996); *see* Basle Committee on Banking Supervision, *Overview of the Amendment to the Capital Accord to Incorporate Market Risks* (January 1996).

4. Another difficulty may be that, under the new guidelines adopted by the Basle Committee, the quantitative standards to be used for the measurement of value-at-risk include standard parameters. In general, it must be deemed inappropriate to establish standard risk parameters for different categories of assets, derivatives, and markets that display different price cycles and volatility characteristics, and rates of change therein.

Chapter 16, Comment (Harris)

1. Office of the Comptroller of the Currency [OCC], *Banking Circular No. 277: Risk Management of Financial Derivatives* (October 27, 1993), *reprinted in part in* 4 *Current Legal Issues Affecting Central Banks* 780 (Robert C. Effros ed., 1997).

2. OCC, *OCC Bulletin 94-31: Questions and Answers Re: BC-277: Risk Management of Financial Derivatives* (May 10, 1994).

3. OCC, *OCC Advisory Letter 94-2: Purchases of Structured Notes* (July 21, 1994).

4. OCC, *Risk Management of Financial Derivatives: Comptroller's Handbook* (October 1994).

5. OCC, *OCC Advisory Letter 95–1: Interest Rate Risk* (February 8, 1995).

6. OCC, *Futures Commission Merchant Activities* (November 1995).

7. OCC, *Emerging Market Country Products and Trading Activities* (December 20, 1995); *see also* OCC, *News Release 95-139: OCC Issues Examiner Guidance on Emerging Market Country Products and Trading Activities* (December 20, 1995). The latter document can be found at the OCC's home page at: www.occ.treas.gov/.

8. OCC, *OCC 96-25: Fiduciary Risk Management of Derivatives* (May 2, 1996); OCC, *News Release 96-52: National Banks Cautioned on Derivatives in Fiduciary Accounts (May 2, 1996).* Both documents are available at the OCC's home page. *See supra* note 7.

9. *See* Daniel Dunaief, *BT Settles a Derivatives Case for $67M*, American Banker, January 25, 1996.

10. Government Securities Sales Practices, 61 Federal Register [Fed. Reg.] 18,469 (1996) (to be codified at 12 Code of Federal Regulations parts 13, 108, 211, and 368) (proposed April 25, 1996); *see* Government Securities Sales Practices, 62 Fed. Reg. 13,275 (1997) (final rule), as amended 62 Fed. Reg. 15,600 (1997).

11. *See id.*

12. *Procter & Gamble Co. v. Bankers Trust Co.,* 925 F. Supp. 1270, 1291 (S.D. Ohio 1996); *see* Bankers Trust, *Bankers Trust and Procter & Gamble Settle Dispute,* Press Release (May 9, 1996); *see also* James C. Allen, *Caution Becomes the Rule for Derivatives Users,* American Banker, June 4, 1996, at 3A.

13. Government Securities Act Amendments of 1993, Public Law No. 103-202, 107 Stat. 2344 (1993) (amending scattered sections of 15 U.S.C. § 78c *et seq.* and 31 U.S.C. § 3130 (1995)); *see* Government Securities Sales Practices, *supra* note 10.

14. *Principles and Practices for Wholesale Financial Market Transactions* (undated), *reprinted in* 4 *Current Legal Issues Affecting Central Banks, supra* note 1, at 786.

Chapter 17, "International Law of Bank Secrecy" (Wood)

1. Much of the information in this chapter is derived from two books on international bank secrecy: *International Bank Secrecy* (Dennis Campbell ed., 1992) (containing sur-

veys of legislation from 36 countries and the European Community); ***Bank Confidentiality*** (Francis Neate and Roger McCormick eds., 1990) (containing surveys of legislation from 16 countries). Also of note is the Jack Committee Report in the United Kingdom. Review Committee on Banking Services Law, ***Banking Services: Law and Practice, Report by the Review Committee,*** Command Paper 622 (February 1989) [hereinafter Jack Report].

The literature on money laundering is substantial. ***See, for example, International Guide to Money Laundering Law and Practice*** (Richard Parlour ed., 1995) (containing general essays and surveys of legislation from 14 countries); 2 ***Current Legal Issues Affecting Central Banks*** (Robert C. Effros ed., 1994) (containing an article and several appendices concerning money laundering); 3 ***Current Legal Issues Affecting Central Banks*** (Robert C. Effros ed., 1995) (also containing appendices concerning money laundering).

There is a significant amount of literature on tax havens, bank supervision, and international civil litigation (apart from domestic works on evidence and judicial procedures). ***See, e.g.,*** Marc Dassesse, Stuart Isaacs, and Graham Penn, ***EC Banking Law*** (2d ed. 1994); ***Banks: Fraud and Crime*** (Joseph J. Norton ed., 1994); ***Obtaining Evidence in Another Jurisdiction in Business Disputes*** (Charles Platto and Michael Lee eds., 2d ed. 1993) (addressing issues other than bank secrecy); Walter H. Diamond and D.B. Diamond, ***Tax Havens of the World*** (MB) (containing some information about bank secrecy).

2. ***See*** Philip R. Wood, ***Comparative Financial Law*** (1995).

3. The British Bankers' Association, The Building Societies Association, and The Association for Payment Clearing Services, ***Good Banking*** (2d ed. March 1994), ***reprinted in*** 3 ***Current Legal Issues Affecting Central Banks, supra*** note 1, at 541; ***see*** Bundesverband deutscher Banken, ***General Business Conditions*** (1993), ***reprinted in*** 3 ***Current Legal Issues Affecting Central Banks, supra,*** at 559; Netherlands Bankers' Association, ***General Conditions*** (1988), ***reprinted in*** 3 ***Current Legal Issues Affecting Central Banks, supra,*** at 573.

4. In the United Kingdom, the British Bankers' Association, prompted by the Jack Report, ***see supra*** note 1, prepared such a code of practice. ***See supra*** note 3.

5. New Zealand Bankers' Association, ***Code of Banking Practice*** (2d ed. 1996).

6. ***Tournier v. National Provincial and Union Bank of England*** [1924], 1 King's Bench [K.B.] 461 (C.A. 1923); ***see infra*** text accompanying note 7.

7. ***Tournier, supra*** note 6.

8. 367 P.2d 284 (Idaho 1961).

9. 224 So. 2d 759 (Fla. Dist. Ct. App. 1969).

10. ***See*** Philippe Giroux, ***France, in Bank Confidentiality, supra*** note 1, at 116 (quoting Article 378 of the 1810 Penal Code).

11. Alex Schmitt and Luc Frieden, ***Luxembourg, in Bank Confidentiality, supra*** note 1, at 159, 166.

12. Giroux, ***supra*** note 10, at 116 (citing Article 57 of the Law of January 24, 1984).

13. The Banking Act [Zákon o bankách], No. 21/1992 Coll. of December 20, 1991, § 38, ***in Banking and the Foreign Exchange Act*** 57, 69 (1992).

14. ***Id.*** § 38(2), (3).

15. Banking Act, 1971, Chapter 19, § 47.

16. Bahamas Bank and Trust Company Regulation Act, 1965, Chapter 64, § 10 (as amended).

17. Ley de Instituciones de Crédito [Law of Credit Institutions], Art. 117, Diario Oficial de la Federación el día 18 de julio de 1990 [Official Journal of the Federation of July 18, 1990], ***reprinted in Leyes y Códigos de México: Legislación Bancaria*** 1, 39 (36th ed. 1991); ***see*** Daniel del Río and José F. Salem, ***Mexico, in International Bank Secrecy, supra*** note 1, at 483, 485.

18. ***See*** Aliya Yusuf, ***Pakistan, in International Bank Secrecy, supra*** note 1, at 547, 550 ***et seq.*** (analyzing the Protection of Economic Reforms Act 1992).

19. Francisco Santana Guapo, *Portugal, in International Bank Secrecy, supra* note 1, at 567 (citing Decree Law Number 2/78 of January 9, 1978).

20. Council Directive 91/308 of 10 June 1991 on the Prevention of the Use of the Financial System for the Purpose of Money Laundering, 1991 Official Journal of the European Communities [O.J.] (L 166) 77, *reprinted in* 3 *Current Legal Issues Affecting Central Banks, supra* note 1, at 420.

21. Guapo, *supra* note 19, at 573 (quoting Article 618 of the Code of Civil Proceedings).

22. *See* Young Moo Kim and Soo Man Park, *South Korea, in International Bank Secrecy, supra* note 1, at 621, 622.

23. Loi fédérale sur les banques et les caisses d'épargne du 8 novembre 1934 [Federal Law on Banks and Savings Banks of November 8, 1934], Art. 47 (as amended, March 24, 1995); *see* Hans Bollmann, *Switzerland, in International Bank Secrecy, supra* note 1, at 663, 666.

24. *See id.* at 667.

25. *See* Juan Fernández-Armesto and Linda Hiniker, *Spain, in Bank Confidentiality, supra* note 1, at 187 (quoting Article 18.1 of the Spanish Constitution).

26. *See* Wolfgang Hauser, *Germany, in Bank Confidentiality, supra* note 1, at 129 (discussing protections under Article 2 of Germany's Constitution).

27. *See, for example, United States v. Miller*, 425 U.S. 435 (1976); *see also* Fernández-Armesto and Hiniker, *supra* note 25, at 643–644 (discussing cases involving Spain's constitutional law).

28. *See supra* the text accompanying note 6.

29. *See supra* the text accompanying note 6.

30. Loi fédérale sur les banques et les caisses d'épargne, *supra* note 23, Art. 2(1); *see* Bollmann, *supra* note 23, at 670.

31. *See id.* at 671–672 (quoting Article 47 of the Bank and Savings Bank Federal Act of June 8, 1934 and noting the term "mandatories" means "any person to whom the bank has given a bank-related task, regardless of its extent. By analogy, in cases where the mandatory (or agent) is a legal person, all persons who have any kind of relationship with the mandatory legal person (once again, managers, employees, officers) are subjected to the duty of confidentiality owed by the legal person . . .").

32. *Bank of Tokyo Ltd. v. Karoon* [1987], Appeal Cases [App. Cas.] 45 (1984).

33. *See* Guy Harles, *Luxembourg, in International Bank Secrecy, supra* note 1, at 471, 478.

34. *See* Angeline Yap, *Singapore, in International Bank Secrecy, supra* note 1, at 577, 593–594.

35. *Harris v. United States*, 413 F.2d 316, 319 (9th Cir. 1969).

36. *Pollock v. United States*, 202 F.2d 281 (5th Cir. 1953), *cert. denied*, 345 U.S. 993 (1953).

37. *See* Odile Lajoix and Marc Billiau, *France, in International Bank Secrecy, supra* note 1, at 187, 189 (discussing and quoting the opinion of the Court of First Instance of Paris in *Banque* 1991 at 985 (Judgment of March 21, 1991)).

38. Stelios N. Deverakis, *Greece, in International Bank Secrecy, supra* note 1, at 273, 276 (referring to exception to duty of secrecy contained in Law Decree 1325 of 1972).

39. 31 Code of Federal Regulations part 103 (1996).

40. *Kabwand Pty. Ltd. v. National Australia Bank Ltd.* [1989], A.T.P.R. 40-950; *see* Jon Broadley, *Australia, in International Bank Secrecy, supra* note 1, at 3, 4–5 (discussing this case).

41. *See* Broadley, *supra* note 40, at 7 (discussing *Smith v. Commonwealth Bank of Australia*, unreported decision of Judge Von Doussa, Federal Court, March 11, 1991).

42. [1992] 3 Weekly Law Reports [W.L.R.] 936 (on appeal from Bermuda).

43. (1985) 52 Ontario Reports 2d 473.

44. *American Medicorp Inc. v. Continental Illinois National Bank & Trust Co. of Chicago*, 475 F. Supp. 5 (N.D. Ill. 1977) (confidential information cannot be used). *But see Washington Steel Corp. v. TW Corp.*, 602 F.2d 594 (3d Cir. 1979) (no absolute duty not to use confidential information because a bank should not make loans blindly).

45. *See* Gill Goodwin and Simon Fraser, *New Zealand, in International Bank Secrecy, supra* note 1, at 531–532 (discussing this point and citing *National Mortgage & Agency Co. of New Zealand Ltd. v. Stalker* [1933], New Zealand Law Reports 1182; *Goodwin v. National Bank of Australasia Ltd.* [1968], 42 A.L.J.R. 110).

46. Broadley, *supra* note 40, at 23–24 (discussing *Ross v. Bank of New South Wales*, (1928) (New South Wales) S.R. 539 and *Goodwin v. National Bank of Australasia*, *supra* note 45).

47. Michael Kutschera, *Austria, in International Bank Secrecy, supra* note 1, at 39, 48.

48. Chris Sunt and Jacques Richelle, *Belgium, in International Bank Secrecy, supra* note 1, at 79, 80–81 (discussing the tort remedy for breach of secrecy contained in Article 1382).

49. *Id.* at 80.

50. Article 134 of Japan's Criminal Code, which imposes criminal sanctions on doctors and similar professionals who breach confidentiality, does not apply to bankers.

51. Sebastiaan A. Boele, *The Netherlands, in International Bank Secrecy, supra* note 1, at 491, 492.

52. Banking Act of 1993, § 38.

53. *See* Michael Paton and Lennox Paton, *The Bahamas, in International Bank Secrecy, supra* note 1, at 61, 63–65 (quoting section 10 of the Banks and Trust Companies Regulation Act).

54. W.S. Walker, *The Cayman Islands, in International Bank Secrecy, supra* note 1, at 147, 148–150 (discussing the Confidential Relationships (Preservation) Order, 1976).

55. Peter Anthoni and Katariina Kivenheimo, *Finland, in International Bank Secrecy, supra* note 1, at 171, 184.

56. Lajoix and Billiau, *supra* note 37, at 197–198 (discussing criminal sanctions under the Banking Law).

57. Deverakis, *supra* note 38, at 295–297 (quoting Code of Criminal Law, Law 1492 of 1950, Article 371 and Law Decree 1059 of 1971, as amended). Prosecution under the 1950 law is only upon a complaint by a person prejudiced and is not automatic by the country. *Id.* at 295. Prosecution under the 1971 law does not require initiation by the person prejudiced. *Id.* at 296.

58. *See* Schmitt and Frieden, *supra* note 11, at 159–160 (discussing Article 458 of the Penal Code and Article 31 of the Law of November 27, 1984).

59. Professional Secrecy Act, 1994.

60. *See* del Río and Salem, *supra* note 17, at 487–488.

61. *See* Yap, *supra* note 34, at 595.

62. *See* Kim and Park, *supra* note 22, at 628 (discussing criminal sanctions under Article 6 of the Real Name Financial Transaction Law).

63. *See* Bollmann, *supra* note 23, at 666–668 (describing penalties for violation of bank secrecy under section 47 of the Bank and Savings Bank Federal Act of 1934).

64. Convention on the Law Applicable to Contractual Obligations, June 19, 1980, *reprinted in* Richard Plender, *The European Contracts Convention* 199 (1991).

65. *See* Jack Report, *supra* note 1, paragraph 5.26, at 34.

66. *See Restatement (Third) of the Law of Foreign Relations* § 442 (1987); *Société Internationale pour Participations Industrielles et Commerciales, S.A. v. Rogers*, 357 U.S. 197 (1958) (good faith defense recognized by Supreme Court); *Ings v. Ferguson*, 282 F.2d 149 (2d Cir. 1960) (New York offices of Canadian banks not required to produce

Canadian documents); *United States v. First National City Bank*, 396 F.2d 897, 902 (2d Cir. 1968) (enumerating factors involved in good faith determination). *But see United States v. Bank of Nova Scotia II (In re Grand Jury Proceedings the Bank of Nova Scotia)*, 740 F.2d 817 (11th Cir. 1984), *cert. denied*, 469 U.S. 1106 (1985) (Circuit court holding that bank failed to act in good faith by not producing more than one document relating to grand jury subpoena).

67. Kutschera, *supra* note 47, at 50.

68. Federal Rules of Civil Procedure, Rule 26(b)(1), 28 U.S.C. Rule 26(b)(1) (1994).

69. Yap, *supra* note 34, at 590 (citing Section 47 of the Banking Act, as amended).

70. Harles, *supra* note 33, at 475–476.

71. *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.* [1964], App. Cas. 465 (1963) (England); *First Virginia Bankshares v. Benson*, 559 F.2d 1307 (5th Cir. 1977) (U.S.).

72. Broadley, *supra* note 40, at 25–26.

73. Jane Bogaty *et al.*, *Canada, in International Bank Secrecy, supra* note 1, at 115, 123.

74. *Id.*

75. Kutschera, *supra* note 47, at 46–47.

76. *See* Finn Martensen and Anders Tolborg, *Denmark, in International Bank Secrecy, supra* note 1, at 157, 159 (discussing the *Rules and Instructions for the Financial Institutions' Release of Credit Reports, 1988*).

77. *See supra* note 3.

78. *Code of Banking Practice, supra* note 5, paragraph 2.4 at 4.

79. *See* Finn Arnesen, *Norway, in International Bank Secrecy, supra* note 1, at 537, 538.

80. *See* Yusuf, *supra* note 18, at 553–554 (quoting section 93C of the Banking Companies Ordinance, 1962).

81. Yap, *supra* note 34, at 590–591 (noting the exceptions to Section 47).

82. *See* Kim and Park, *supra* note 22, at 623.

83. *Lee Gleeson Pty. Ltd. v. Sterling Estates Pty. Ltd.* (1991), 23 New South Wales Law Reports 571.

84. *Sunderland v. Barclays Bank Ltd.*, 5 Legal Decisions Affecting Bankers 163 (Maurice Megrah ed., 1955).

85. Kutschera, *supra* note 47, at 47–48.

86. *Graney Development Corp. v. Taksen*, 400 N.Y.S.2d 717 (1978), *affirmed*, 411 N.Y.S. 2d 756 (1978); *Sharma v. Skaarup Ship Management Corp.*, 699 F. Supp. 440 (S.D.N.Y. 1988).

87. *Tournier, supra* note 6.

88. *Canadian Imperial Bank of Commerce v. Sayani*, 83 British Columbia Law Reports 2d 167 (1991); *see* Bogaty *et al.*, *supra* note 73, at 130.

89. *R v. Curtis*, Court of Appeals 346/93 (December 3, 1993) (unreported) (alleged forgery).

90. Basle Committee on Banking Supervision, *Statement on the Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering* (December 1988), *reprinted in 2 Current Legal Issues Affecting Central Banks, supra* note 1, at 327.

91. UN Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, U.N. Docs. E/Conf. 82/15 and E/Conf. 82/14 (December 19, 1988) [hereinafter Vienna Convention], *reprinted in 2 Current Legal Issues Affecting Central Banks, supra* note 1, at 375.

92. Vienna Convention, *supra* note 90, Art. 3.

93. *Id.* Art. 7.

94. *Id.* Art. 5(3).

95. Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime, Eur. Consult. Ass., Doc. No. 141 (November 8, 1990), *reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 1, at 331.

96. *Scheme Relating to Mutual Assistance in Criminal Matters Within the Commonwealth* (as amended, 1990), *reprinted in* David McClean, *International Judicial Assistance* 331 (1992).

97. Money-Laundering Directive, *supra* note 20. The recitals to the Council Directive record the following considerations (in summary):

- If financial institutions "are used to launder proceeds from criminal activities, . . . the soundness and stability of the institution concerned and the confidence in the financial system as a whole could be seriously jeopardized, thereby losing the trust of the public."
- Coordination is required to ensure that launderers do not take advantage of the freedom of finance in the European Union by seeking out the least restrictive regime.
- The growth of organized crime in general, and drug trafficking in particular, is a threat to the societies of member states, and combating money laundering is one of the most effective means of opposing these crimes.
- The financial system can play a highly effective role in combating money laundering.
- Since money laundering is international, it needs to be combated at the international level.
- It is necessary to lift bank secrecy.

Article 1 provides that, in general, the Directive applies to credit institutions, certain other financial institutions (such as securities firms), insurance companies, and branches within the Community of institutions that have their head offices outside of the Community. In addition, it contains a detailed definition of money laundering, which includes (i) the conversion or transfer of property, with the knowledge that it is derived from criminal activities, for the purpose of concealing or disguising its illicit origin; (ii) the concealment or disguise of proceeds, with the knowledge that they are derived from criminal activities; (iii) the acquisition or possession of property, with the knowledge that it is derived from criminal activities; and (iv) participation in, facilitating, or aiding and abetting the above activities. In contrast to the normal criminal law, subjective intent is not required because knowledge may be inferred from the objective factual circumstances. Moreover, it is immaterial that the crime that generated the property was perpetrated in another member state or in a third country. Crimes are not only the Vienna Convention drug crimes, *see supra* note 90, but all criminal activity designated as such for the purposes of the Directive by each member state.

Article 2 provides that member states shall ensure that money laundering is prohibited.

Pursuant to Article 3, member states are to ensure that credit and financial institutions require identification of their customers. This identification requirement also applies to others who carry out transactions involving a sum of ECU 15,000 or more (aggregating linked transactions). There are detailed provisions for insurance policy premiums and pension schemes. If there is doubt as to whether customers are acting on their own behalf, institutions must take reasonable measures to obtain information as to the real identity of the beneficial owners—so as to see through nominees, agents, and trusts. Identification is required, even where the amount of the transaction is lower than the threshold, whenever there is a suspicion of money laundering. Identification does not apply to customers that are credit or financial institutions covered by the directive. Article 4 provides for the maintenance of identification and transaction records for five years.

Article 6 sets forth the compulsory disclosure provision. Institutions and their employees must cooperate fully with the authorities responsible for combating money laundering

by informing those authorities, on their own initiative, of any fact that might be an indication of money laundering and by furnishing those authorities, at their request, with all necessary information. Information supplied to the authorities may be used only in connection with the combating of money laundering. However, member states may provide that the information may also be used for other purposes; it is open to member states to allow a transmittal of the information to other regulatory authorities and the fiscal authorities.

Article 7 provides that institutions must not carry out transactions that they know or suspect to be related to money laundering until they have informed the authorities, who may direct nonexecution. However, if this is likely to frustrate efforts to pursue the beneficiaries of money laundering, for example, by tipping them off, the institution must inform the authorities immediately after the transaction. Pursuant to Article 8, institutions must not inform the customer or third parties that the information has been transmitted to the authorities in order to prevent tipping off. The disclosure "in good faith" to the authorities by an employee is not to constitute a breach of any secrecy duty. *Id.* Art. 9.

Pursuant to Article 10, member states are to ensure that if, in the course of inspections carried out on institutions by the competent authorities or in any other way, those authorities discover facts that could constitute evidence of money laundering, they must inform the money laundering authority. Article 11 provides that institutions must establish adequate control and communication procedures and carry out training programs.

Finally, the Directive's money-laundering provisions are to be extended in whole or in part to other professions and undertakings that engage in activities that are particularly likely to be used for money-laundering purposes. *Id.* Art. 12.

See Paolo Clarotti, ***Banking Law Developments in the European Union: Deposit Insurance and Money Laundering Initiatives,*** 4 *Current Legal Issues Affecting Central Banks* 105 (Robert C. Effros ed., 1997).

98. Organization of American States, Model Regulations Concerning Laundering Offenses Connected to Illicit Drug Trafficking and Related Offenses, AG/RES. 1198 (XXII-0192), eighth plenary session (May 23, 1992), *reprinted in* 3 *Current Legal Issues Affecting Central Banks, supra* note 1, at 308.

99. Financial Action Task Force, *Report of the Financial Action Task Force on Money Laundering* (February 6, 1990), *reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 1, at 350.

100. 31 Code of Federal Regulations §§ 103.22, 103.28 (1995).

101. *See* Peter Willis *et al.*, *Australia, in International Guide to Money Laundering Law and Practice, supra* note 1, at 33 (discussing the requirement under the Cash Transactions Reports Act, 1988, to report any transactions over $10,000).

102. *Code of Conduct for Members of the Association of International Banks and Trust Companies in the Bahamas* (undated), *reprinted in International Bank Secrecy, supra* note 1, at 73.

103. *See* Wendy Fowler, *Great Britain, in International Bank Secrecy, supra* note 1, at 243, 262 (discussing the Guidance Notes on money laundering).

104. *See id.* at 259–260.

105. *See R v. Serious Fraud Office* [1992], 3 All England Law Reports [All Eng. Rep.] 456.

106. *Williams v. Summerfield* [1972], 2 Queen's Bench 512.

107. *Bankers Trust Co. v. Shapira* [1980], 3 All Eng. Rep. 353.

108. Office of the Superintendent of Financial Institutions, *Best Practices for Deterring and Detecting Money Laundering* (effective January 1, 1990); *see* Bogaty *et al.*, *supra* note 73, at 134 *et seq.*

109. Loi No. 84-46 du 24 janvier 1984 relative à l'activité et au contrôle des établissements de crédit, Art. 57, Journal Officiel 390, 396 (January 25, 1984).

110. Harald Jung, *Germany, in International Bank Secrecy, supra* note 1, at 213, 219 (citing paragraphs 94 *et seq.* of the Code of Criminal Procedure).

111. *See* Deverakis, *supra* note 38, at 273, 285 (describing the case and citing Athens Appeal Court Decree 1465 of 1988, reported in Nomico Vima (1988), Volume 36, at pp. 1274–1276 and Athens Appeal Court Decree 2432 of 1988, reported in Elliniki Dikaeosyni (1990), Volume 31, at pp. 918–921).

112. Law 1868 of October 10, 1989.

113. *See* Deverakis, *supra* note 38, at 290–291.

114. Joe Varley and James Dudley, *Ireland, in International Bank Secrecy, supra* note 1, at 331, 351–352 (summarizing *Alan Clancy and David McCartney v. Ireland and the Attorney General,* Barrington J., unreported, High Court, May 4, 1988).

115. *See* Cesare Vento and Raffaella Betti Berutto, *Italy, in International Bank Secrecy, supra* note 1, at 387, 394 *et seq.*

116. Harles, *supra* note 33, at 475–476.

117. *See* John Koh and Yeoh Lian Chuan, *Singapore, in International Guide to Money Laundering Law and Practice, supra* note 1, at 141, 143–144; *Statement of Principles, supra* note 89.

118. Kim and Park, *supra* note 22, at 627.

119. Agreement on the Swiss Banks' Code of Conduct with Regard to the Exercise of Due Diligence between the Swiss Bankers Association and the Signatory Banks (July 1, 1992).

120. Public Law No. 91-508, 84 Stat. 1114 (1970) (codified as amended at scattered sections in 12 and 31 U.S.C.), *reprinted in part in* 2 *Current Legal Issues Affecting Central Banks, supra* note 1, at 421.

121. Public Law No. 95-630, 92 Stat. 3641 (1978) (codified as amended at scattered sections in 12 U.S.C.).

122. Public Law No. 99-570, 100 Stat. 3207 (1986) (codified as amended at scattered sections in 12, 18, and 31 U.S.C.).

123. *See supra* note 121.

124. *See supra* note 120.

125. 18 U.S.C. § 1956 (1994).

126. *See* Council Directive 91/308, *supra* note 20, Art. 1; *see also supra* note 97.

127. 12 U.S.C. § 3403(c) (1994).

128. *See United States v. Bank of New England, N.A.,* 821 F.2d 844 (1st Cir. 1987), *cert. denied*, 484 U.S. 943 (1987).

129. European Convention on Extradition, done at Paris on December 13, 1957, and entered into force on April 18, 1960, 359 United Nations Treaty Series 274.

130. European Convention on Mutual Assistance in Criminal Matters, done at Strasbourg, April 20, 1959, and entered into force on June 12, 1962.

131. Inter-American Convention on Mutual Assistance in Criminal Matters, signed on May 23, 1992.

132. *See supra* note 91.

133. *See supra* note 20.

134. Model Treaty on Mutual Assistance in Criminal Matters, December 14, 1990, 68th plenary meeting, A/RES/45/117 (1990).

135. *See* Paton and Paton, *supra* note 53, at 61, 70, note 10 (citing *United States v. LeMire* (Cayman Islands Court of Appeal 1983), *The Wall Street Journal*, January 11, 1983).

136. *See id.* at 71, note 11 (citing *Royal Bank of Canada v. Apollo Development Ltd.* (1985) (unreported)).

137. *Re Bank of America*, No. 923 of 1993 (unreported).

138. *United States v. Bank of Nova Scotia,* 740 F.2d 817 (11th Cir. 1984), *cert. denied,* 469 U.S. 1106 (1985); *see also United States v. Bank of Nova Scotia,* 691 F.2d 1384 (11th Cir. 1982), *cert. denied,* 462 U.S. 1119 (1983).

139. *SEC v. Banca Della Svizzeria Italiana*, 92 F.R.D. 111 (1981).

140. Criminal Justice (International Co-operation) Act, 1990, Chapter 5, § 4.

141. *Bonalumi v. Home Department* [1985], 1 All Eng. Rep. 797.

142. *Spencer v. The Queen,* 21 Dominion Law Reports 4th 756 (Supreme Court of Canada 1985).

143. Harles, *supra* note 33, at 477 (describing the Court of Appeal of Luxembourg's reluctance in *Banco Ambrosiano*, July 1, 1988, Number 71/88 ChdC, to give information to foreign authorities that could not be obtained through letter rogatory).

144. *Id.*

145. *Id.* (citing the Benelux Treaty on Judicial Co-operation in Criminal Matters, Brussels, June 27, 1962).

146. *See supra* note 130.

147. Bollmann, *supra* note 23, at 688.

148. *See* U.S. General Accounting Office, *Money Laundering: A Framework for Understanding U.S. Efforts Overseas,* GAO/GGD-96–105, Appendix 1, at 26 (May 1996) (listing countries that have signed bilateral agreements with the United States to share information on criminal, currency, and customs matters).

149. Council Directive 89/592 of 13 November 1989 Coordinating Regulations on Insider Dealing, 1989 O.J. (L 334) 30 [hereinafter Insider Dealing Directive].

150. *See* Barrie Meerkin, *Hong Kong, in International Bank Secrecy, supra* note 1, at 327 (discussing Chapter 333 of the Laws of Hong Kong).

151. Financial Services Act, 1986, Chapter 60, § 177.

152. Insider Dealing Directive, *supra* note 149.

153. *Id.* Art. 9.

154. *Id.* Art. 10.

155. *Id.* Art. 10(3).

156. *Id.* Art. 10(2)(a).

157. 86 Civ. 3726 (1986).

158. Bollmann, *supra* note 23, at 697-698.

159. *See Switzerland: Swiss Supreme Court Opinion Concerning Judicial Assistance in the Santa Fe Case*, 22 International Legal Materials [I.L.M.] 785 (1983); *see also United Kingdom: High Court of Justice (Queen's Bench Division) Judgment Concerning Judicial Assistance in the Santa Fe Case,* 23 I.L.M. 511 (1984).

160. Bank Act, 1987, Chapter 22, § 39.

161. *Id.* § 82(2).

162. *Id.* § 83(1).

163. *Id.* § 84.

164. *Id.* § 85.

165. Yap, *supra* note 34, at 599–600 (discussing the decision reported in The Times, October 30, 1991).

166. [1992] 1 All Eng. Rep. 769.

167. [1992] 1 All Eng. Rep. 778.

168. *Melton Medes Ltd. v. Securities and Investment Board* (1994), The Times, July 27, 1994 (alleged wrongful disclosure by the Securities and Investments Board in relation to pension funds being investigated by the regulatory authority).

169. *Kaufman v. Crédit Lyonnais* (December 20, 1994) (unreported) (Judge Arden).

170. *See supra* note 109.

171. *See* Lajoix and Billiau, *supra* note 37, at 205–206 (discussing Article 5B of the Law of September 28, 1967, as modified by Law Number 89-531 of August 2, 1989).

172. Hauser, *supra* note 26, at 132.

173. Deverakis, *supra* note 38, at 290; *see id.* at 285–286 (discussing the *Bank of Crete* case).

174. The risk of damages liability if an authority discloses information wrongfully is demonstrated by litigation on tax treaties. Thus, in 1980 a Brussels court held that a Belgian company was entitled to damages where the Belgian tax authorities, without authorization, had informed the Italian tax authorities about Italian residents to whom the company had paid "secret" commissions. The Italians had subsequently refused to do business with the Belgian company.

175. In the European Union, the First and Second Banking Directives and the Post-BCCI Banking Directives contain provisions on secrecy. First Council Directive 77/780 of 12 December 1977, 1977 O.J. (L 322) 30; Second Council Directive 89/646 of 15 December 1989, 1989 O.J. (L 386) 1; Council Directive 95/26, 1995 O.J. (L 168) 7. The secrecy provisions are contained in Article 12 of the First Banking Directive, which was replaced by Article 16 of the Second Banking Directive, which was amended by the Post-BCCI Directive. These secrecy duties apply, in general, to information under the other banking directives, for example, on capital adequacy and solvency. For example, the Consolidated Supervision Directive of 1992 provides for the consolidated supervision of banks and other institutions and, accordingly, breaks down the veil of incorporation to enable exchanges of information about all members of a banking group. Council Directive 92/30 of 6 April 1992 on the Supervision of Credit Institutions on a Consolidated Basis, 1992 O.J. (L 280) 54. The First and Second Banking Directive and the Directive on the Supervision of Credit Institutions are reprinted in Volumes 1 and 2 of *Current Legal Issues Affecting Central Banks, supra* note 1.

176. First Banking Directive, *supra* note 175, Art. 12(1).

177. *Id.* Art. 12(4) (as set forth in the Second Banking Directive, *supra* note 175, Art. 16).

178. This is potentially a very wide exception, having regard to the ambit of criminal law where many minor delinquencies are criminalized, for example, minor corporate offences. It may also permit disclosure to the fiscal authorities in the case of tax fraud and to the authorities in charge of economic law, for example, antitrust activities.

179. *See* Marc Dassesse *et al.*, *EC Banking Law* 210–212 (2d ed. 1994).

180. *See supra* note 20.

181. [1989] 3 All Eng. Rep. 252 (1987).

182. [1991] 2 All Eng. Rep. 865 (1991).

183. [1993] 1 All Eng. Rep. 748 (1992).

184. *See* Harles, *supra* note 33, at 474.

185. Loi fédérale sur les banques et les caisses d'épargne, *supra* note 23, Art. 23 sexies.

186. Financial Services Act, 1986, Chapter 60, § 177.

187. *See* Meerkin, *supra* note 150, at 325.

188. *See* W.G. Horton, *Canada, in Obtaining Evidence in Another Jurisdiction in Business Disputes, supra* note 1, at 145.

189. British Companies Act, 1985, Chapter 6, § 212. Banking legislation generally requires complete identification of controllers and major shareholdings above a certain threshold.

190. *Id.* § 721. These provisions are mirrored by more draconian provisions for the investigation of banks.

191. *Id.* §§ 431–453. These inspections could be initiated by the Department of Trade and Industry, for example.

192. *See* Varley and Dudley, *supra* note 114, at 352.

193. *See id.* at 353.

194. *See* Broadley, *supra* note 40, at 16.

195. *See id.* at 17 (discussing *Australian Securities Commission v. Zarro,* 10 A.C.L.C. 11 (1992), in which a bank had to produce customer documents even though the Commission did not assert a connection between the documents and the alleged matters being investigated).

196. *See, e.g.,* Cash Transactions Reports Act, 1988, No. 64, §§ 3, 7 (Australia).

197. *See* Broadley, *supra* note 40, at 12–13 (summarizing the holdings in *Allen, Allen and Hemsley v. Deputy Federal Commission of Taxation,* and *Clarke v. Deputy Federal Commission of Taxation*).

198. *See id.* at 13 (discussing *Citibank Ltd. v. Commission of Taxation* in which tax authorities were enjoined from entering the Citibank premises after they conducted an unannounced raid to inspect customer records without firm evidence that the records were relevant).

199. *See* Fowler, *supra* note 103, at 258.

200. Income and Corporation Taxes Act, 1988, Chapter 1, § 745.

201. *Clinch v. Inland Revenue Commissioners,* 1 All Eng. Rep. 977 (1973).

202. *See* David W. Drinkwater and James E. Fordyce, *Canada, in Bank Confidentiality, supra* note 1, at 67.

203. *See* Lajoix and Billiau, *supra* note 37, at 200–201.

204. *See* Jung, *supra* note 110, at 220 (discussing the scope of a bank's duty to reveal information in criminal tax proceedings and tax investigation proceedings).

205. *See id.* at 224.

206. *See* Deverakis, *supra* note 38, at 287.

207. *See id.* at 288.

208. *See* Vento and Berutto, *supra* note 115, at 391–394.

209. *See* Harles, *supra* note 33, at 473.

210. *See* Goodwin and Fraser, *supra* note 45, at 523.

211. *See id.*

212. *See* Fernández-Armesto and Hiniker, *supra* note 25, at 188–189.

213. *See* Bollmann, *supra* note 23, at 678.

214. *United States v. Miller,* 425 U.S. 435 (1976).

215. *Holman v. Johnson,* 98 Eng. Rep. 1120, 1121 (1975).

216. [1983] 2 All Eng. Rep. 464.

217. *See* Meerkin, *supra* note 150, at 317–319.

218. *See* Fowler, *supra* note 103, at 251–252.

219. *See* Hauser, *supra* note 26, at 136–137.

220. Organization for Economic Cooperation and Development, Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, April 11, 1977.

221. Council Directive 77/799 of 19 December 1977 concerning Mutual Assistance by the Competent Authorities of the Member States in the Field of Direct Taxation, 1977 O.J. (L 336) 15.

222. *See* First Council Directive 67/277, 1971 O.J. (L 71) 1301; Sixth Council Directive 77/388, 1977 O.J. (L 145) 1.

223. Model Convention, *supra* note 220, Art. 26(2)(c).

224. *Id.*

225. *See* Bollmann, *supra* note 23, at 691–692 (describing circumstances when the lifting of secrecy is permitted).

226. Transfer pricing is the practice of selling goods to a tax haven company that then on-sells at a large profit.

227. *See supra* note 6.

228. *See* Danci Penn, *British Virgin Islands, in International Bank Secrecy, supra* note 1, at 101, 107.

229. *See id.* at 107–108.
230. *See infra* note 281.
231. *See id.* at 110.
232. *See id.* at 109–110.
233. *See supra* note 6.
234. *See* Walker, *supra* note 54, at 148–149.
235. *See id.* at 149 (listing the exceptions, which include criminal offenses inside or outside the Cayman Islands).
236. *See id.* at 152; *see also* the Mutual Legal Assistance (United States of America) Law, 1986.
237. B.J. Marrache and G.V. Davis, *Gibraltar, in International Bank Secrecy, supra* note 1, at 233.
238. *See supra* note 6.
239. M. Linda Grant and Rita L. Joseph, *Grenada, in International Bank Secrecy, supra* note 1, at 303–304, 306.
240. *Id.* at 306–307.
241. *Id.* at 308.
242. *Id.* at 308–309.
243. *See supra* note 6.
244. Paul R. Beckett, *Isle of Man, in International Bank Secrecy, supra* note 1, at 370–372.
245. *See supra* note 6.
246. *See* David Lyons, *Jersey, in International Bank Secrecy, supra* note 1, at 399–426; *see also Statement of Principles, supra* note 90.
247. Federal Rules of Civil Procedure, Rules 26–37, 28 U.S.C. Rules 26–37 (1994). The compulsion procedures for nonparties are in Federal Rules of Civil Procedure Rule 45. 28 U.S.C. Rule 45 (1994).
248. [1956] 1 Queen's Bench 618 (1955).
249. 482 U.S. 522 (1987).
250. *Id.* at 542.
251. *See infra* the discussion under the heading "Tracing Assets."
252. Bankers' Books Evidence Act, 1879, 42 and 43 Vict., Chapter 11, § 3.
253. Penn, *supra* note 228, at 102–103.
254. Yap, *supra* note 34, at 601.
255. *See DB Deniz Nakliyati TAS v. Yugopetrol* [1992], 1 All Eng. Rep. 205 (1991) (a case on a postjudgment order); *see also* Goodwin and Fraser, *supra* note 45, at 522–523 (summarizing *James v. Mabin (No. 3)*).
256. *See Rex v. Daye* [1908], 2 K.B. 333 (1908); *Senior v. Holdsworth* [1975], 2 All Eng. Rep. 1009 (1975); Varley and Dudley, *supra* note 114, at 350–360 (summarizing *Cully v. Northern Bank Finance Corp. Ltd.*, in which the bank was not required to produce documents whose existence was speculative).
257. Varley and Dudley, *supra* note 114, at 336–338.
258. *Id.* at 337.
259. *Commissioner for Railways v. Small* [1938], 38 (New South Wales) S.R. 564.
260. [1994] 1 W.L.R. 1493 (on appeal from the Eastern Caribbean Court of Appeal (St. Vincent and the Grenadines)).
261. Goodwin and Fraser, *supra* note 45, at 522–523.
262. Martensen and Tolborg, *supra* note 76, at 163.
263. *See supra* note 109.
264. Harles, *supra* note 33, at 475–476.
265. *See* Code of Civil Proceedings, Art. 618.
266. Yap, *supra* note 34, at 593.

267. Felix López Antón, *Spain, in International Bank Secrecy, supra* note 1, at 645–646.

268. [1973] 1 All Eng. Rep. 609 (1972).

269. Varley and Dudley, *supra* note 114, at 357.

270. Lajoix and Billiau, *supra* note 37, at 206–207.

271. Deverakis, *supra* note 38, at 278.

272. *Id.* at 278–279.

273. *Id.* at 279–280.

274. *Id.* at 294.

275. *Norwich Pharmacal Co. v. Commissioners of Customs and Excise* [1973], 2 All Eng. Rep. 943 (1973). (Customs authorities, who had cleared goods allegedly imported in breach of a patent, were obliged to disclose the identity of the importers to the owner of the patent.)

276. [1980] 3 All Eng. Rep. 353.

277. *See Mediterranea Raffineria Siciliana Petroli Spa v. Mabariaft GmbH*, Court of Appeals (Civil Division) Transcript 816 (1978) (unreported) (where the court allowed a discovery order for lost proceeds of sale).

278. *Chief Constable of Kent v. V* [1982], 3 All Eng. Rep. 36.

279. The Times, December 27, 1994.

280. Peter J. Perry, *Australia, in Obtaining Evidence in Another Jurisdiction in Business Disputes, supra* note 1, at 3, 4–5 (discussing *National Mutual v. Sentry Corp.*).

281. The Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, March 18, 1970, is the most notable example of multilateral convention involving letters of request. The text of the 1970 Hague Convention is reprinted *in Obtaining Evidence in Another Jurisdiction in Business Disputes, supra* note 1, at 191–199.

282. These are often on Hague Convention lines. Belgium has treaties with at least 14 countries. Peter Vandeghinste and Jeroen Dossche, *Belgium, in Obtaining Evidence in Another Jurisdiction in Business Disputes, supra* note 1, at 69, 74–76 (listing and explaining Belgium's bilateral conventions). Canada has at least 20 treaties.

283. Japan has treaties with the United Kingdom (1964) and the United States (1963). Takanobu Takehara and Takashi Yoneda, *Japan, in Obtaining Evidence in Another Jurisdiction in Business Disputes, supra* note 1, at 27, 29–30 (discussing procedures under these consular conventions).

284. Requests are both inward and outward. Invariably, the evidence must comply with local rules and must not conflict with local public policy or national security. It is almost always the case that these exchanges apply only to judicial proceedings in the courts, not to regulatory authorities, such as the Securities and Exchange Commission.

285. *See supra* note 281.

286. Evidence (Proceedings in Other Jurisdictions) Act 1975, Chapter 34, §§ 1–4.

287. *See, e.g., Rio Tinto Zinc Corp. v. Westinghouse Corp.* [1978], 1 All Eng. Rep. 434 (1977); *Re Asbestos Insurance Coverage Cases* [1985], 1 All Eng. Rep. 716; *Re Country of Norway's Applications* [1989], 1 All Eng. Rep. 745 (the court must weigh the wish to help foreign court against upholding foreign bank secrecy); *SEC v. Stockholders of Santa Fe International Corp.*, 23 I.L.M. 511 (1984).

288. [1986] 1 All Eng. Rep. 653 (1985).

289. Richard Grandison, *England, in Bank Confidentiality, supra* note 1, at 92-93.

290. [1993] Butterworth's Company Law Cases [B.C.L.C.] 396.

291. *See supra* note 6.

292. Varley and Dudley, *supra* note 114, at 338–340 (summarizing case).

293. *See generally,* W.G. Horton, *Canada, in Obtaining Evidence in Another Jurisdiction in Business Disputes, supra* note 1, at 142–152 (comparing Canada Evidence Act and Ontario Evidence Act).

294. Bogaty *et al.*, *supra* note 73, at 140.

295. *Id.* at 140–141.

296. Takehara and Yoneda, *supra* note 283, at 28.

297. 28 U.S.C. § 1782 (1994).

298. *See supra* note 281.

299. Inter-American Convention on Letters Rogatory, done on January 30, 1975, *reprinted in* 14 I.L.M. 329 (1975).

300. The following countries are parties to the 1970 Hague Convention: Argentina, Australia, Barbados, Cyprus, the Czech Republic, Denmark, Finland, France, Germany, Israel, Italy, Luxembourg, Mexico, Monaco, the Netherlands, Norway, Portugal, Singapore, the Slovak Republic, Spain, Sweden, the United Kingdom (including Gibraltar and Hong Kong), and the United States. Many have made reservations to the Convention.

301. Inter-American Convention on Letters Rogatory, *supra* note 299, Art. 2. The parties to the Convention include Argentina, Chile, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Hungary, Mexico, Panama, Paraguay, Peru, Spain, the United States, and Venezuela.

302. *Id.* Art. 3.

303. *Id.* Art. 10.

304. *Id.* Art. 17.

305. Insolvency Act, 1986, Chapter 45, § 236.

306. *See Cloverbay Ltd. v. BCCI SA* [1991], 1 All Eng. Rep. 894 (1990); *Re Barlow Clowes Gilt Managers Ltd.* [1991], B.C.C. 608. *But see British and Commonwealth Holdings plc v. Spicer and Oppenheim* [1993], App. Cas. 426 (1992) (compelling auditors to disclose documents even though this might incriminate them for negligence).

307. (1991) 5 Western Weekly Reports 281 (Saskatchewan).

308. *See* Bogaty *et al.*, *supra* note 73, at 128 (summarizing this case).

309. *See id.* (summarizing this case).

310. Giroux, *supra* note 10, at 126 (discussing Article 49 of the Law of January 1984).

311. Lajoix and Billiau, *supra* note 37, at 208.

312. Giroux, *supra* note 10, at 127.

313. Deverakis, *supra* note 38, at 284.

314. Bollmann, *supra* note 23, at 676.

315. *See, e.g.*, 11 U.S.C. § 304 (1994); the Swiss Private International Law Act of 1987, Arts. 166–175.

316. *Re Gee*, 53 B.R. 891 (Bankruptcy Court, S.D.N.Y. 1985).

317. *Re International Power Industries N.V.* [1985], B.C.L.C. 128 (refusing to allow an examination of an Antilles' company's English director and solicitors).

318. *Re Seagull Manufacturing Co.* [1991], B.C.C. 550.

319. Uniform Commercial Code § 9-302 (1990).

320. Not Quebec nor the Maritime provinces.

321. Lajoix and Billiau, *supra* note 37, at 190.

322. *Id.* at 191–192 (discussing the decision of the Appeals Court of Paris, March 20, 1990).

323. Deverakis, *supra* note 38, at 292 (discussing Law 1738 of 1987 and Law 1868 of 1989).

Chapter **17**, Comment (Ross)

1. The Financial Action Task Force (FATF) was established at the Group of Seven Economic Summit in 1989. Its membership currently includes the 24 member countries of the Organization for Economic Cooperation and Development, the European Union, the Gulf Cooperation Council, Hong Kong, and Singapore. *See* Financial Action Task Force, *Report of the Financial Action Task Force on Money Laundering* (February 6, 1990), *reprint-*

ed in part in 2 *Current Legal Issues Affecting Central Banks* 350 (Robert C. Effros ed., 1994).

2. AG/RES. 1198 (XXII-0192), 8th plenary session (May 23, 1992), *reprinted in* 3 *Current Legal Issues Affecting Central Banks* 308 (Robert C. Effros ed., 1995).

3. Caribbean Financial Action Task Force, *19 Aruba Recommendations* (June 1990); Caribbean Financial Action Task Force, *Kingston Declaration on Money Laundering* (November 5–6, 1992). Both documents are reprinted in Financial Crimes Enforcement Network, U.S. Department of the Treasury, *Compendium of International Anti-Money Laundering Conventions and Agreements* (2d ed., January 1996).

4. Basle Committee on Banking Supervision, *Statement of Principles Concerning Prevention of Criminal Use of the Banking System for the Purpose of Money-Laundering* (December 1988), *reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 1, at 327.

5. United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, U.N. Docs. E/Conf. 82/15 and E/Conf. 82/14 (December 19, 1988), *reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 1, at 375.

6. Council Directive 91/308 of 10 June 1991 on the Prevention of the Use of the Financial System for the Purpose of Money Laundering, 1991 Official Journal of the European Communities (L 166) 77, *reprinted in* 3 *Current Legal Issues Affecting Central Banks, supra* note 2, at 420.

7. Council of Europe Convention on Laundering, Search, Seizure, and Confiscation of the Proceeds from Crime, Eur. Consult. Ass., Doc. No. 141 (November 8, 1990), *reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 1, at 331. The Convention was adopted on September 8, 1990 and entered into force in September 1993, following its ratification by Bulgaria, Switzerland, the Netherlands, and the United Kingdom. The Council of Europe is an intergovernmental organization with approximately 26 members.

8. Ministerial Conference Concerning the Laundering of Proceeds and Instrumentalities of Crime, *Ministerial Communiqué* (December 2, 1995), *reprinted in Compendium of International Anti-Money Laundering Conventions and Agreements, supra* note 3, at 131.

9. *United States v. Miller,* 425 U.S. 435 (1976).

10. Bank Records and Foreign Transactions Act (commonly referred to as the "Bank Secrecy Act"), Public Law No. 91-508, Titles I and II, 84 Stat. 1114, 1124 (1970) (codified primarily at 12 U.S.C. §§ 1730d, 1829b, and 1951–59 (1994)) [hereinafter Bank Secrecy Act].

11. *California Bankers Association v. Shultz,* 416 U.S. 21 (1974).

12. *United States v. Miller, supra* note 9.

13. Right to Financial Privacy Act, Public Law No. 95-630, 92 Stat. 3697 (1978) (codified and amended at 12 U.S.C. §§ 3401–3422 (1994)).

14. 31 Code of Federal Regulations [C.F.R.] § 103.22 (1997); *see* 31 U.S.C. §§ 321, 5311–5326 (1994), *reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 1, at 421.

15. 31 C.F.R. § 103.21 (1997).

16. *Id.* § 103.33.

17. 18 U.S.C. §§ 981, 982, 1956, 1957 (1994), *reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 1, at 408; *see* United States General Accounting Office, *Money Laundering: A Framework for Understanding U.S. Efforts Overseas*, GAO/GGD-91–105 (May 1996).

18. Bank Secrecy Act, *supra* note 10.

19. 31 C.F.R. § 103.22.

20. *Id.* § 103.23.

21. Amendment to the Bank Secrecy Act Regulations—Exemptions from the Requirement to Report Transactions in Currency, 61 Federal Register 18,203 (1996) (Interim rule amending 31 Code of Federal Regulations part 103).

22. Minimum Security Devices and Procedures, Report of Suspicious Activities, and Bank Secrecy Act Compliance Program, 61 Federal Register 4332 (1996) (amending 12 Code of Federal Regulations part 21).

23. Since the 1996 IMF Conference, FinCEN, in May 1997, published draft regulations that require money transmitters, and money order and traveler's check issuers and redeemers to file suspicious-activities reports as well. FinCEN likewise is drafting suspicious-reporting regulations for casinos.

24. 31 U.S.C. § 5318(g) (1994).

25. 18 U.S.C. §§ 1956, 1957 (1994).

26. *Id.* §§ 981, 982; 21 U.S.C. § 881 (1994).

27. *See supra* note 2.

28. *See supra* note 8.

29. *See Money Laundering: A Framework for Understanding U.S. Efforts Overseas, supra* note 17, at 26–27.

30. *Id.*

Chapter 18, "Financial Services in the General Agreement on Trade in Services: Framework and the 1995 Negotiations" (Kono and Low)

1. This chapter was presented by Patrick Low. The biography of his co-author, Masamichi Kono, also appears in the biographical sketches.

2. General Agreement on Trade in Services, Annex on Financial Services, ¶ 5(a), *in* The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, April 15, 1994. The GATS is reprinted in 4 *Current Legal Issues Affecting Central Banks* 597 (Robert C. Effros ed., 1997).

The following resources were used by the authors in preparing this chapter: Jagdish N. Bhagwati, *Splintering and Disembodiment of Services and Developing Nations*, 7 The World Economy 133 (1984); Richard Cooper, *Survey of Issues and Review in* Leslie V. Castle and Christopher Findlay, *Pacific Trade in Services* 247 (1988); Roger Kampf, *A Step in the Right Direction: The Interim Deal on Financial Services in the GATS, in* 5 International Trade Law and Regulation 157 (1995); Fariborz Moshirian, *Trade in Financial Services*, 17 The World Economy 347 (1994); James Bedore, *Financial Services: An Overview of the World Trade Organization's Negotiations*, Industry, Trade, and Technology Review 1 (December 1995); James Bedore, *Financial Services: The Negotiation's Goal,* Industry, Trade, and Technology Review 2 (December 1995); The World Bank, *Global Economic Prospects and the Developing Countries* (1995).

3. Banking and other financial services are widely defined under the GATS. GATS, *supra* note 2, Annex on Financial Services, 5(a). They include acceptance of deposits; lending; financial leasing; payment and money transmission services; guarantees and commitments; trading (in money market instruments, foreign exchange, derivative products, exchange rate and interest rate instruments, transferable securities, and other negotiable instruments and financial assets); participation in issues of securities; money brokering; asset management; settlement and clearing services; provision and transfer of financial information (including financial data processing); and advisory and intermediation services. *Id.* Insurance services encompass direct insurance (life and nonlife), reinsurance and retrocession, insurance intermediation, and auxiliary insurance services (including consultancy, actuarial, risk assessment, and claim settlement services). *Id.*

4. Bedore, *supra* note 2, at 1 note 2 (citing Journal of Commerce, July 27, 1994, at 1 and The Financial Times, July 27, 1995, at 5).

5. *See* Kathleen M. O'Day, *GATT and Its Effect on Banking Services, in* 4 *Current Legal Issues Affecting Central Banks, supra* note 2, at 131.

6. Moshirian, *supra* note 2, at 347.

7. Information technology is a general term covering computer and communications technology used to generate, process, analyze, and transmit information. World Bank, *supra* note 2, at 44 and 45.

8. The perceived need for effective supervision by host country authorities might be reflected in the entry of relatively liberal commitments under Mode 3 (commercial presence) for financial services compared to Mode 1 (cross-border supply), particularly when active marketing by financial service suppliers is involved. However, increasingly, international cooperation between supervisory authorities and enhanced supervision techniques have started to question such differentiation.

9. Cooper, *supra* note 2, at 252.

10. World Bank, *supra* note 2, at 47, Box 3-2.

11. The implied allocation of locally generated output as domestic sales or foreign trade on the basis of the ownership of the equity responsible for production appears to have limited economic relevance. Yet under the GATS, governments have assumed obligations in respect of production attributable to foreign equity.

12. Bhagwati, *supra* note 2, at 136.

13. GATS, *supra* note 2, Art. I(2)(a).

14. *Id.* Art. I(2)(b). Both a service supplier and a service consumer could, of course, move to a third jurisdiction. Under the GATS, this would be treated as two separate transactions from the point of view of the host country.

15. *Id.* Art. I(2)(c).

16. *Id.* Art. I(2)(d).

17. Gary P. Sampson and Richard H. Snape, *Identifying the Issues in Trade in Services,* 8 The World Economy 171, 172–173 (1985).

18. GATS, *supra* note 2, Art. I(3)(c).

19. *Id.*

20. *Id.* Art. II(1).

21. *Id.* Art. II(2).

22. *Id.* Annex on Article II Exemptions.

23. *Id.* Art. VI(2).

24. *Id.* Art. V.

25. *Id.* Art. VII.

26. *Id.* Art. VIII.

27. *Id.* Art. IX.

28. Among the more significant of the commitment-specific provisions are those relating to domestic regulation in paragraphs 5 and 6 of Article VI on domestic regulation. Restrictions to safeguard the balance of payments (Article XII) are also relevant only when a member has scheduled specific commitments to liberalize trade in services. General and security exceptions (Articles XIV and XIV *bis*) are applicable to all sectors, but their practical significance lies in sectors for which commitments have been undertaken. No provisions have been established for emergency safeguard action, for procurement disciplines, or on specific rules to cover subsidies. Negotiations are, however, mandated in each of these subject areas. Work is also being done to develop disciplines relating to domestic regulation (Article VI(4)), which would apply to all measures relating to qualifications, technical standards, and licensing, although the work has initially started in the area of professional services, with priority in the accountancy sector.

29. *See* General Agreement on Tariffs and Trade 1994, Art. III.

30. Exceptions to national treatment under the GATT exist in respect of subsidies and government procurement. *Id.* Art. III(8).

31. GATS, *supra* note 2, Annex on Financial Services, ¶ 2(b).

32. *Id.* ¶ 3.

33. *Id.* ¶ 4.

34. *Id.* ¶ 5.

35. Twenty-seven countries, counting the member states of the European Community individually and Aruba, had done so. Most countries in the OECD adopted this "formula approach" or "top-down approach" as an alternative to the general "bottom-up" approach.

36. Understanding on Commitments in Financial Services, *in* The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations (December 15, 1993), *reprinted in* 4 *Current Legal Issues Affecting Central Banks, supra* note 2, at 627.

37. GATS, *supra* note 2, Art. XI(1).

38. *Id.* Art. XVI, note 8.

39. *Id.*

40. These conditions are that the restrictions shall not discriminate among members, shall be consistent with the Articles of Agreement of the IMF, shall be proportionate to the circumstances sought to be dealt with, shall avoid unnecessary damage to the interests of other members, and shall be temporary and be phased out progressively as the situation improves. *Id.* Art. XII(2).

41. *Id.* Art. XII(5)(e).

42. Marrakesh Agreement Establishing the World Trade Organization, April 15, 1994, *in* The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, April 15, 1994.

43. GATS, *supra* note 2, Second Annex on Financial Services ¶ 2.

44. Decision on Financial Services, § 1, *reprinted in The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts* 459 (1994).

45. GATS, *supra* note 2, Second Annex on Financial Services §1

46. Council for Trade in Services, World Trade Organization, Decision on the Application of the Second Annex on Financial Services, W.T.O. Doc. S/L/6 (95–1841) (July 4, 1995) (adopted June 30, 1995).

47. Decision on Financial Services, *supra* note 44, ¶ 2.

48. World Trade Organization, Second Protocol to the General Agreement on Trade in Services, W.T.O. Doc. S/L/11 (95–2165) (July 24, 1995) [hereinafter Protocol], *reprinted in* 35 International Legal Materials [I.L.M.] 203 (1996).

49. Committee on Trade in Financial Services, World Trade Organization, Decision Adopting the Second Protocol to the General Agreement on Trade in Services, W.T.O. Doc. S/L/13 (95–2167) (July 24, 1995) (adopted July 21, 1995), *reprinted in* 35 I.L.M. 206 (1996).

50. Council for Trade in Services, World Trade Organization, Decision on Commitments in Financial Services, W.T.O. Doc. S/L/8 (95–2162) (July 24, 1995) (adopted July 21, 1995), *reprinted in* 35 I.L.M. 204 (1996).

51. Council for Trade in Services, World Trade Organization, Second Decision on Financial Services, W.T.O. Doc. S/L/9 (95–2163) (July 24, 1995) (adopted July 21, 995), *reprinted in* 35 I.L.M. 205 (1996).

52. These countries are Australia, Brazil, Canada, Chile, Colombia, Czech Republic, Dominican Republic, Egypt, the European Union, Hong Kong, Hungary, India, Indonesia, Japan, Korea, Kuwait, Malaysia, Mauritius, Mexico, Morocco, Norway, Pakistan, the Philippines, Poland, Singapore, Slovak Republic, South Africa, Switzerland, Thailand, Turkey, the United States, and Venezuela. The Schedules of Specific Commitments and Lists of Article II (MFN) Exemptions are contained in W.T.O. document series GATS/SC and GATS/EL, country by country, as supplements (Suppl. 1).

53. Protocal, *supra* note 48.

54. Second Decision on Financial Services, *supra* note 51, ¶ 1, 2.

Chapter 18, Comment (Siegel)

1. General Agreement on Trade in Services, *in* The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, December 15, 1993 [hereinafter GATS], *reprinted in* 4 *Current Legal Issues Affecting Central Banks* 597 (Robert C. Effros ed., 1997).

2. The North American Free Trade Agreement, December 8, 11, 14, and 17, 1992, Canada-Mexico-United States [hereinafter NAFTA], *reprinted in part in* 4 *Current Legal Issues Affecting Central Banks, supra* note 1, at 632.

3. In addition to the annexes applicable to certain specific chapters, the NAFTA contains the following annexes: Annex I: Reservations for Existing Measures and Liberalization Commitments; Annex II: Reservations for Future Measures; Annex III: Activities Reserved to the State; Annex IV: Exceptions from Most-Favored-Nation Treatment; Annex V: Quantitative Restrictions; Annex VI: Miscellaneous Commitments; and Annex VII: Reservations, Specific Commitments, and Other Items.

4. 2 *The GATT Uruguay Round: A Negotiating History (1986–1992)* 2354–2358 (Terence P. Stewart ed., 1993).

5. NAFTA, *supra* note 2, Art. 1405(1) (emphasis added). There are two additional national treatment provisions in this article of NAFTA—one concerning financial institutions of another party and investments of investors of another party in financial institutions (paragraph 2) and another concerning cross-border trade by financial service providers (paragraph 3). The provisions have essentially equal effect and were separated primarily to avoid awkward drafting.

6. GATS, *supra* note 1, Art. XVII(1) (emphasis added).

7. In the General Agreement on Tariffs and Trade, which served as a model for the GATS, the national treatment obligation is a general, and indeed a fundamental, obligation. General Agreement on Tariffs and Trade 1994, December 15, 1993, Art. II [hereinafter GATT], *reprinted in The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts* 21–23, 185 (1994). The GATS is thus less ambitious on this point.

8. Certain commitments in the financial services area that otherwise required scheduling were "standardized" in the Understanding on Commitments in Financial Services, which applies to those countries that have endorsed it. Understanding on Commitment in Financial Services, *in* The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, December 15, 1993, *reprinted in* 4 *Current Legal Issues Affecting Central Banks, supra* note 1, at 627.

9. NAFTA, *supra* note 2, Art. 1403.

10. *Id.* Art 1403(5). Other limitations of this obligation are that the party may impose certain terms and conditions consistent with national treatment, or the party may require the entity to incorporate. *Id.* Art. 1403(4).

11. *Id.* Art. 1404(1).

12. Mexico took the following noteworthy reservation to the obligation on cross-border trade:

> In order to avoid impairment of the conduct of Mexico's monetary and exchange rate policies, cross-border financial service providers of another Party shall not be permitted to provide financial services into the territory of Mexico or to residents of Mexico, and residents of Mexico may not purchase financial services from cross-border financial service providers of another Party, if such transactions are denominated in Mexican pesos.

Id. Annex VII, Schedule of Mexico, Section B, paragraph 16.

13. *Id.* Art. 1404(2).

14. *Id.*
15. *Id.* Art. 1408.
16. GATS, *supra* note 1, Art. XVI(1) (emphasis added and footnote omitted).
17. *Id.* Annex on Article II Exemptions.
18. *Id.* Art. XVI(2) (emphasis added).
19. GATS, *supra* note 1, Art. XVI(1), note 8. This rule is in a footnote to the market access provision, which is somewhat unusual in international agreements. Nonetheless, it has no less force under the GATS.
20. NAFTA, *supra* note 2, Art. 1406(1) (emphasis added).
21. GATS, *supra* note 1, Art. II(1) (emphasis added).
22. *Id.* Art. II(2).
23. *Id.* Annex on Article II Exemptions.
24. NAFTA, *supra* note 2, Art. 1410(2).
25. GATS, *supra* note 1, Art. I(3)(b).
26. *Id.*, Annex on Financial Services, paragraph 1(b) and (c). Paragraph 1(b) and (c) state:

> (b) For the purposes of subparagraph 3(b) of Article I of the Agreement,'services supplied in the exercise of government authority' means the following:
> (i) activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies;
> (ii) activities forming part of a statutory system of social security or public retirement plans; and
> (iii) other activities conducted by a public entity for the account or with the guarantee or using the financial resources of the Government.
> (c) For the purposes of subparagraph 3(b) of Article I of the Agreement, if a Member allows any of the activities referred to in subparagraphs (b)(ii) or (b)(iii) of this paragraph to be conducted by its financial service suppliers in competition with a public entity or financial services supplier, 'services' shall include such activities.

27. *See, for example,* Japan—Trade in Semi-Conductors, *in* GATT, *Basic Instruments and Selected Documents* 116 (Supp. No. 35, 1987–88).
28. NAFTA, *supra* note 2, Art. 1410(1).
29. *GATS, supra* note 1, *Annex on Financial Services,* paragraph 2(a).
30. Keith Palzer, *The Implications of NAFTA for Central Banks, in* 4 *Current Legal Issues Affecting Central Banks, supra* note 1, at 143.
31. *See herein* Masamichi Kono and Patrick Low, *Financial Services in the GATS: A Continuing Negotiation,* at 493 (emphasis added).
32. As the GATT did not cover financial services, there is no precedent of providing an exception for "prudential" reasons, but see the analysis on an analogous issue of an exception for measures "necessary" to protect human, animal, or plant life or health. U.S. Restrictions on Imports of Tuna, *in* GATT, *Basic Instruments and Selected Documents* 155, paragraph 5.27, at 199 (Supp. No. 39, 1991–1992). The GATS employs another method to control overuse of the exception, which is to state that the prudential measures exception shall not be used as a means of avoiding the member's commitments or obligations under the Agreement. GATS, *supra* note 1, Annex on Financial Services, paragraph 2(a).

Chapter **18,** Comment (Muench)

1. General Agreement on Trade in Services [GATS], *in* The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, December 15, 1993. The GATS is reprinted in 4 *Current Legal Issues Affecting Central Banks* 597 (Robert C. Effros ed., 1997).
2. GATS, *supra* note 1, Annex on Financial Services.
3. *Id.* paragraph 2(a).

4. *Id.* paragraph 5.

5. *Id.* paragraph 1(b).

6. Trade Act of 1974, Public Law No. 93-618, 88 Stat. 1978 (1975) (codified primarily at 19 U.S.C. § 2101 *et seq.* (1994)).

7. 19 U.S.C. § 2191 (1994).

8. *Id.* § 2191(d).

9. *Id.* §§ 2112(c)–(e), 2155.

10. *Id.* § 2155.

11. *Id.* § 2902(a).

12. *Id.* § 2902(e).

13. Uruguay Round Agreements Act, Public Law No. 103-465, 108 Stat. 4809 (1994) (codified at 19 U.S.C. § 3501 *et seq.* (1994)); *see* The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, December 15, 1993.

14. 19 U.S.C. § 3555 (1994).

15. *Id.* § 3555(a).

16. North American Free Trade Agreement, December 8, 11, 14, and 17, 1992, Canada-Mexico-United States, Chapter 14. Selected provisions of NAFTA are reprinted in 4 *Current Legal Issues Affecting Central Banks, supra* note 1.

17. *See supra* Deborah Siegel, *Comment* (to Chapter 18) (addressing the differences between the financial services provisions of the NAFTA and GATT).

18. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Public Law No. 103-328, 108 Stat. 2338 (1994).

Biographical Sketches

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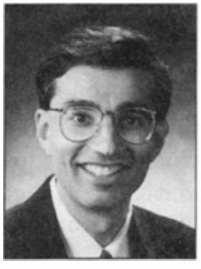

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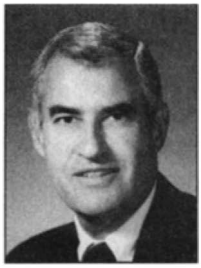

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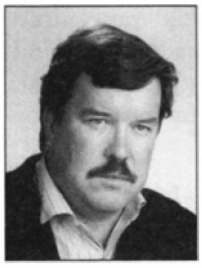

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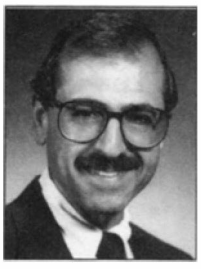
Herbert V. Morais received his bachelor of laws degree from the University of Singapore and his master of laws and doctor of juridical science degrees in international law from Harvard Law School, where he was a Fulbright and Harvard Scholar. From 1968 to 1970, he was Sub-Dean and Lecturer in Law at the University of Singapore. During 1970 to 1973, he was in private practice, first with the law firm of Donaldson & Burkinshaw in Kuala Lumpur and Singapore, and then with Sullivan & Cromwell in New York. For the past 25 years, Mr. Morais has been a practicing international lawyer, holding senior legal positions with three major international financial institutions—the Asian Development Bank, the World Bank, and the International Monetary Fund, where he has served as Assistant General Counsel since March 1994. As Chief Counsel in the World Bank, Mr. Morais was the principal lawyer responsible for negotiating World Bank participation in several major sovereign debt rescheduling transactions (particularly under the Brady initiative) and in several project finance and cofinancing transactions. As Assistant General Counsel in the IMF, Mr. Morais works primarily on general policy issues and new initiatives in the areas of international monetary and financial law.



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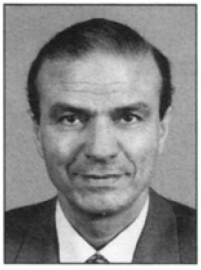

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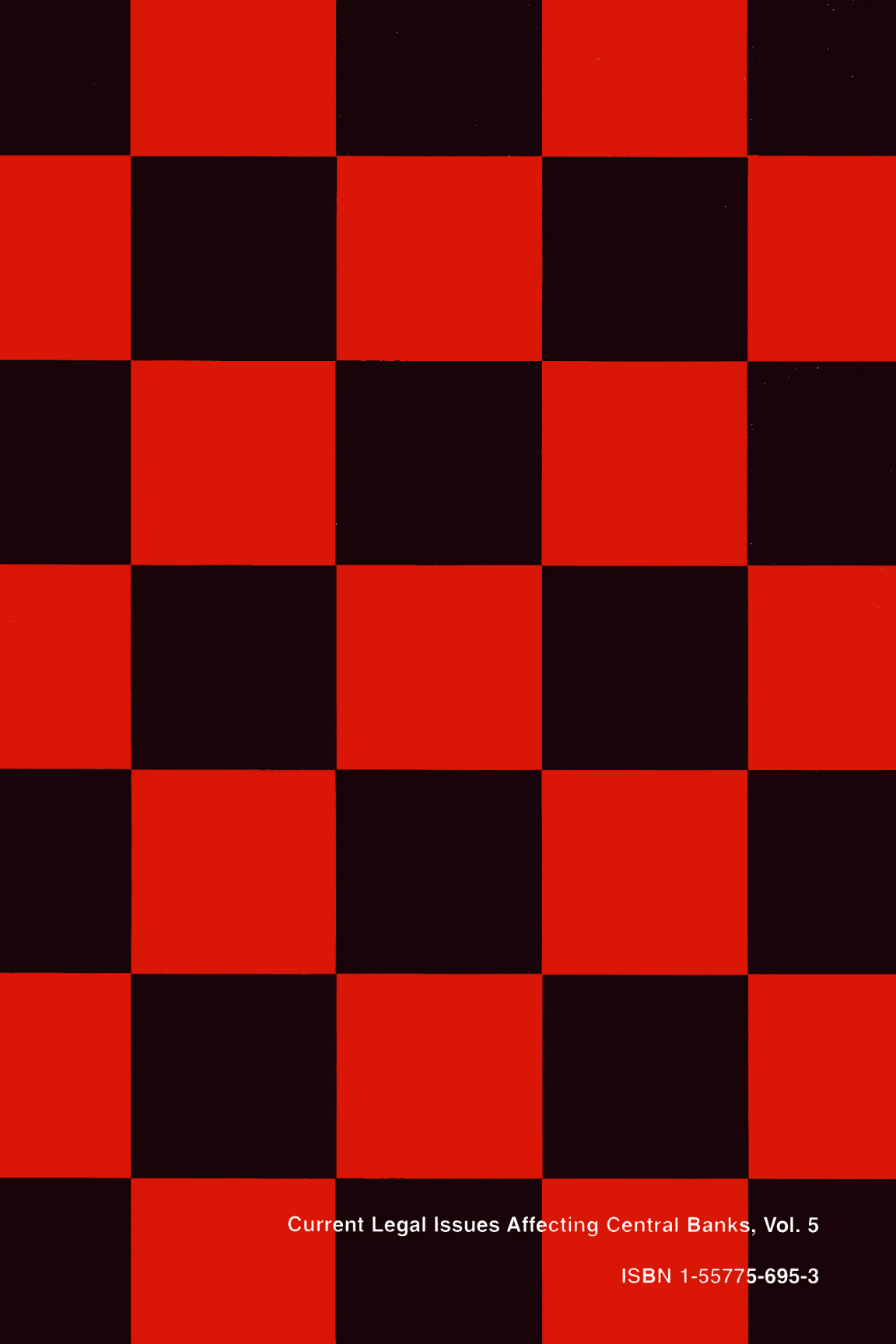

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