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Lessons from the Iranian Experience: NATIONAL CURRENCIES AS INTERNATIONAL MONEY

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MR. MUNDHEIM: We are ready now to look at the U.S. government freeze of Iranian government assets and some of the implications that action has for banking and lending policies and practices. John Hoffman, who, as counsel for a major bank, played a leading role in the negotiations which resulted in the release of the hostages held in Iran and in the unfreezing of a substantial portion of the Iranian assets held by U.S. banks, will begin our discussion.

1. THE IRANIAN EXPERIENCE

MR. HOFFMAN: It is fair to say that from the very imposition of the Iranian asset freeze, attention focused on the question of the consequences of the freeze and the lessons to be learned from the experience, wholly apart from the question of the effectiveness of the freeze as a means to compel the Iranians to perform in a way satisfactory to the U.S. government.

There was a great deal of consideration given to the potential effect of the freeze on the foreign exchange markets and the money markets. The announcement of a threat by Iran to withdraw its deposits from the U.S. banking system had been one of the factors that triggered the freeze. Ironically, the question arose, would imposition of a freeze have the consequence of influencing withdrawal of other foreign deposits from U.S. banks? Would Eurodollar deposits, particularly in branches of U.S. banks overseas, become a sort of endangered species as a result of this exercise?

As a result of the experience with Iran, we now know more about the nature and liquidity of the Eurodollar market, as well as the risks of placing and receiving Eurodollar deposits within that market. These and other issues that made up the financial backdrop of the Iranian experience will be the subject of our discussion.

A. Imposition of the Freeze

To set the stage, let us turn back to November 1979. You will recall that on November 14, 1979, President Carter imposed a freeze on certain Iranian government and government-related assets. I think it is worth taking a moment to read the presidential announcement. It states: "I, Jimmy Carter, President of the United States, find that the situation in Iran constitutes an unusual and extraordinary threat to the national security, foreign policy and economy of the United States and hereby declare a national emergency to deal with that threat. I hereby order blocked all property and interests in property of the government of Iran, its instrumentalities and controlled entities in the Central Bank of Iran which are or become subject to jurisdiction of the United States, or which are in or come within the possession or control of persons subject to the jurisdiction of the United States." [1]

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At the same time as the Presidential Executive Order was issued, the White House put out a press release further describing the action this way: "The President has today acted to block all official Iranian assets in the United States, including deposits in United States banks and their foreign branches and subsidiaries. This order is in response to reports that the government of Iran is about to withdraw its funds. The purpose of this order is to ensure that claims on Iran by the United States and its citizens are provided for in an orderly manner. The order does not affect accounts of persons other than the government of Iran, the Central Bank of Iran, and other controlled entities. The precise amounts involved cannot be ascertained at this time but there is no reason for disturbance in the foreign exchange or other markets." [2]

The imposition of a freeze of this nature was not a novel exercise on the part of the U.S. government. There were precedents for the regulations that were issued that day to govern the nuts-and-bolts operation of the Iranian freeze. These precedential situations involved Cuba and China as well as other countries. [3]

What did the freeze purport to affect? What was its desired effect, financially and economically? Prior to this time, Iran had been receiving approximately fifty million dollars a day in oil revenue. These funds found their way into deposits that were maintained by Iran with U.S., European, and Japanese banks. Many of these deposits were denominated in dollars at branches of U.S. banks overseas, predominantly in London. These accounts were a prime target for the freeze.

B. Attack on the Freeze Outside the United States

The question of the President's authority to freeze the accounts very quickly became the subject of litigation in London and in Paris. Within two weeks of the imposition of the freeze, the Central Bank of Iran sued five American banks in London (with which it maintained very large dollar deposits) claiming its right to immediate payment of the funds, asserted to be more than three billion dollars in Iranian external reserves. The Iranian complaint was very simple. It stated that Iran had maintained the deposits, that they were now due, that they had been demanded, and that they had not been paid. In effect, Iran came in with a summary judgment application, which said that somebody owed them some money and would not pay it.

C. Defense of the Freeze

The defenses asserted by the banks in these actions were premised on three main theories. One of them, which will be the primary focus of our attention this afternoon, derives from the operation of the presidential freeze. The freeze defense was based on the proposition that the President could freeze dollar deposits maintained on the books of an American bank branch overseas by the imposition of an executive order, without necessarily intruding into the sovereignty of the foreign country where the branches were located or creating a conflict with the laws of that country. More of this in just a moment.

The second line of defense, which was founded on a public policy argument, held that the courts of England should not honor the Iranian claims because they had behaved in a barbaric fashion and had violated the law of nations. A third defense, based on the Breton-

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Woods agreement, would deny Iran the right to recover on the accounts. I do not propose to spend any time discussing the second and third lines of defense, as most of our attention was focused on the first line of defense: namely, the way in which the freeze affected the Eurodollar accounts.

I should mention that the banks all had substantial setoff claims against the deposits, based on their claims against Iran for various loans. Another issue that played a major role in the litigation in Paris involved the proposition, under French law, that if an American bank were precluded, by virtue of some legal problem in the U.S., from paying out dollars from a dollar deposit in France but was not precluded from paying in francs, it had an obligation to convert the dollar claim of Iran into francs. That issue has not yet been resolved and it is doubtful, at this point, that it will be.

I would like to focus our attention on the defense of the American banks based on the operation of the freeze. From a legal and a tactical point of view, it appeared preferable to structure this defense on the premise that the manner of operation of the accounts was well known to the depositor, who understood that no transfers could be made out of a dollar deposit account in London unless the transfers were made through the New York clearing system. Recognition of that fact was, indeed, a term of the contract of deposit. President Carter had therefore acted within the territorial jurisdiction of the U.S. by freezing the ability to transfer the dollar accounts. According to this theory, the freeze would not create any conflict with the laws of England or English national rights.

This was a defense that was to be established by proving the long term method of operation of such accounts. The defense, however, was not tried in the English court, nor will it be, due to the settlement reached in the Algerian accords. This experience provided a crash course for many people in the nature and operations of Eurodollar accounts. I would like to turn to my colleague, Ian Giddy, who will describe in greater detail how the English courts would have come out on this issue had they had the chance.

2. EURODOLLARS AND THE INTERNATIONAL PAYMENTS SYSTEM

MR. GIDDY: This is a story about the Eurodollar market, how transfers are made between banks in the Eurodollar market, how in 1979 Bank Markazi, Iran's Central Bank, expected to receive return of its funds in London despite the deposit freeze, and why it did not. This is also a story about the Eurodollar transfer system and the implications of the freeze for the future of the international payments and the Eurodollar market.

A. Nature of Eurodollars

First, a little lesson in money. One of the initial questions that was asked of me as a consultant to Shearman & Sterling and another law firm in the Iranian deposit freeze case was, are Eurodollars money? And if so, what kind of money? Fortunately, I never had to give the answer in court. But in the professional writing on this subject, most economists agree that Eurodollars are not *money*, strictly defined. They are more akin to what economists define as *quasi-money*.

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The difference is simply that you cannot make a payment with quasi-money; you first have to convert it into something else. Let us get back to the question of what a Eurodollar is, if it is not money.

Eurodollars are bank deposits denominated in dollars outside the borders of the U.S., and Euro-currencies are bank deposits in currencies other than that of the country in which the bank or bank branch is located. There is nothing special about the deposits. They are mostly time deposits. They are simply deposited outside the country of the currency in which they are denominated.

The important feature of Eurodollars is that they are subject to different jurisdictions and, therefore, different regulations. The *sine qua non* of a Eurodollar is that the regulations to which Eurodollar deposits are subject are less onerous, creating lower costs for the banks issuing those deposits. Those lower costs enable the bank to offer a higher interest rate on the deposit, which is what attracts funds out of national markets and into the Eurodollar market.

B. Risks of Holding Eurodollar Deposits

The higher interest rate, though, does not come free. In the Eurodollar market it is accompanied by a different set of risks faced by depositors who place their funds there. Those risks are fairly well understood by depositors, central banks, domestic corporations, and multinational firms. Those risks were fairly well understood, that it, until the Iranian deposit freeze took place; then a new kind of risk was highlighted.

* CONDITION OF BANK
* CENTRAL BANK BACKING
* HOST COUNTRY POLITICAL RISK
* TRANSFER RISK

Exhibit I: EURODOLLARS DEPOSIT RISK

Exhibit 1 lists four sets of Eurodollar risks. These risks include, first, the condition of the bank itself. The second risk arises from the nationality of the bank, or more accurately, the reliance that one can place on the central bank backing it up. One would normally prefer to have a deposit in a bank that has access to the same currency as the one in which the deposit is denominated, which is why American banks have had such an advantage in issuing dollar deposits abroad. The third risk is the host country's political risk or the sovereign risk--in other words, the risk that the Bahamian authorities might freeze up all Eurodollar deposits in Nassau and that the dollars might not be repaid. One could answer that the dollars are not really in Nassau so they can always be repaid; but this is not as clear cut as it seems because, after all,

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there have been instances of countries seizing foreign banks. This occurred, for example, in Saigon and Peru. In some cases, depositors lost their funds entirely, and even those who have recovered their money have suffered extended delays.

The new element of risk is the transfer risk, which arose out of the deposit freeze. The transfer risk stems from the fact that Eurodollars themselves are not narrowly-defined money. They are quasi-money. People do not make payments with Eurodollars. People make payments with U.S. dollars, which means that they make payments through the U.S. banking system. Thus, despite the fact that the Carter deposit freeze applied only within the jurisdiction of the U.S., it effectively applied not only to the assets held within the U.S., but also to the offshore deposits denominated in dollars in U.S. banks in London, in Paris, and elsewhere.

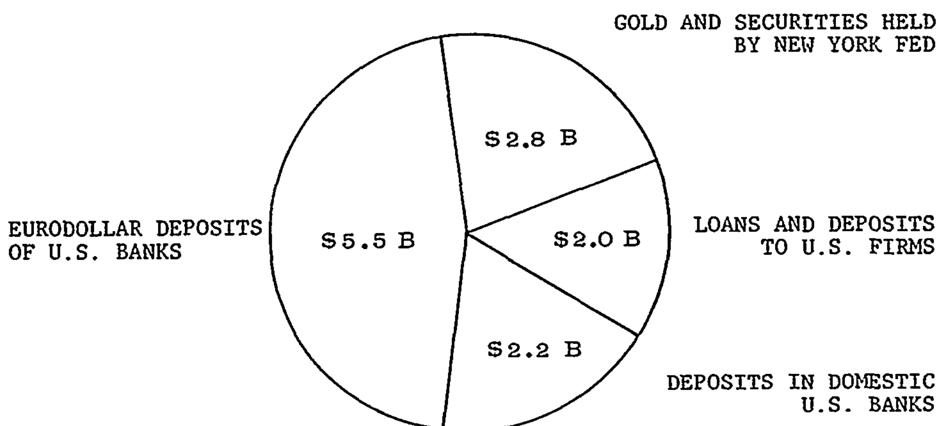

Exhibit 2: OFFICIAL IRANIAN ASSETS FROZEN ON NOV. 14, 1979

Let me refer you to Exhibit 2. Assets of approximately $12 billion were effectively frozen on November 14, 1979. This sum includes gold and securities held in the Fed and the U.S. Treasury (which, of course, were immediately seized), loans and deposits in U.S. firms, and about $2 billion of deposits in U.S. banks. However, about half of the total--for us the more interesting part--was the $5.5 billion in banks abroad, mainly in London, mainly in five U.S. banks.

C. International Dollar Payments System

How was that effectively frozen? Bank Markazi claimed that it was not frozen at all and wanted its money back immediately. Exhibit 3 indicates how the U.S. and international dollar payments system

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works and how Bank Markazi would have received its money. The dollar payments system works quite simply as follows.

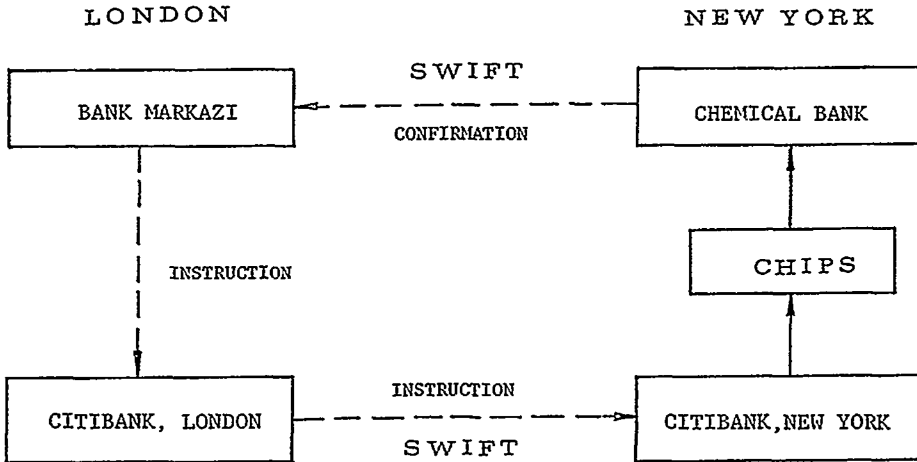

Exhibit 3: THE INTERNATIONAL DOLLAR PAYMENT SYSTEM

Bank Markazi is in London and the dotted line is the demand it put to Citibank and to other banks in London that it wanted its money back--the dollar deposits held in London. It said, "Give it back here in London. It is not in the United States."

A payment between two banks in London, however, is made in New York. This situation puzzles a lot of people including economists, but that is the way it works. To make a payment, Bank Markazi sends an instruction to Citibank in London specifying the amount and exactly which account the money is to be paid into. That specified account is an account in New York, for example, in Chemical Bank if Markazi had an account there.

Citibank, London, of course, has an account in its New York head office. Through the international payments communication system, SWIFT (Society for Worldwide Interbank Financial Transfers), a message is sent to Citibank, New York to remove money from Citibank, London's account and transfer it to Chemical Bank. This transfer is effected through the domestic payments system used for international dollar payments or CHIPS (Clearing House Interbank Payments System), the clearing house system in New York. The payment would be executed on the same day as the instruction is sent from London and the payment issued through the CHIPS system would be paid in so-called clearinghouse funds. The CHIPS system is simply an offsetting mechanism where dozens, indeed hundreds, of banks abroad with accounts

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in New York make payments to one another through other accounts in New York. Every day these totals paid into and out of various banks (and even within banks) are totalled up. At the end of the day the CHIPS people figure out who owes whom what, and the net amount that is owed. The net amount owed between the fourteen settlement banks is then transferred in real money the following day, and the real money is no longer so-called clearinghouse funds but dollar bills or their equivalent, deposits in accounts at the Federal Reserve Bank of New York. Exhibit 4 shows an example of a CHIPS settlement, with Chemical Bank and Citibank making various payments to one another. At the end of day one, the net amount is totalled up and the following day that net amount is paid. If Citibank turns out to owe Chemical Bank a certain amount, it is paid through the "Fed wire", i.e., through transfers between accounts at the New York Federal Reserve or at other Federal Reserve banks.

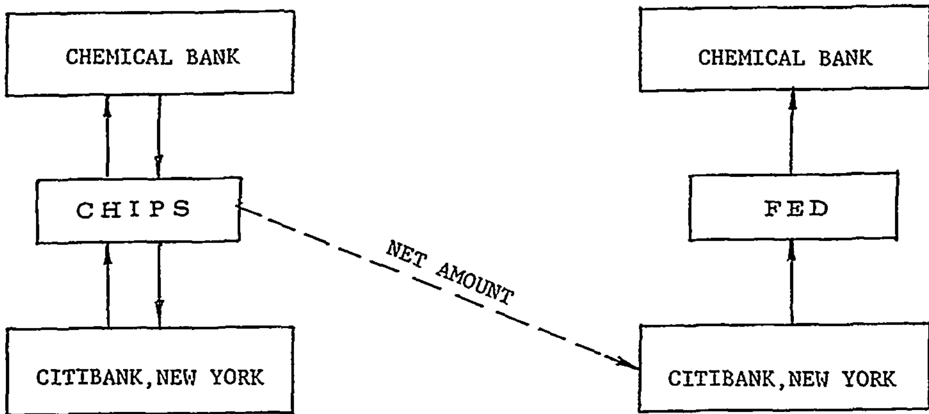

Exhibit 4: TWO U.S. PAYMENT SYSTEMS

That is how it works. It all goes through the U.S. clearing system, CHIPS, and ultimately gets paid in what everybody terms "good money", money that can earn interest because it constitutes scarce reserves at the Fed. Because all this has to go through New York, any payment made between two banks in London, including between Markazi and Citibank, was subject to the freeze the moment it started to pass through the New York clearing system since the freeze applied to transfers not only made by, but also on behalf of, Bank Markazi or any other entity of the national government in Iran. The freeze was not necessarily confined to U.S. banks but the U.S. government chose not to try to impose it on foreign banks as well.

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To conclude, one of the questions that arose out of this case and one of the first thoughts that occurred to Bank Markazi and its lawyers at Stephenson Harwood was, why don't you try to make the payment in some other way? There are several ways in which you can make this payment in London. If Bank Markazi wants to be paid by Citibank, one way is the wheelbarrow method: the dollar bills are wheeled down the Strand in London from Citibank's branch to Markazi's. Unfortunately, the sums involved would have meant such a huge wheelbarrow, such a huge shipment, that the banks were simply going to argue that this was not a normal, accepted means of payment and so they were not obliged to do it.

There are other methods, asserted Markazi. They could have paid in gold or securities, or they could have made the payment in the equivalent amount in some other foreign currency. Citibank and other banks argued, with some merit, that none of these was the normal and expected means of payment. However, of course, the case was never decided in court. So we do not know yet whether the courts would have decided that Citibank was obliged to make that payment.

D. CHIPS

The Iranian freeze called into question the whole system of international financial transfers denominated in dollars. It is a system that has worked extraordinarily well. This system is part of the reason for the fact that fifty-two percent of world trade and seventy-two percent of the Euro-currency market is denominated in U.S. dollars. About ninety-five percent of all foreign exchange transactions in the world goes through the U.S. dollar payments system, even between, for example, the German mark and the Swiss franc. In other words, the CHIPS system has to handle the great bulk of international transactions in the world. On an average day CHIPS handles $160 billion worth of payments, which is confined to international transactions and does not include U.S. transactions. A $160 billion may not sound like very much, but the total world trade that occurred in 1980 was about $1.8 trillion. Therefore, CHIPS could handle in twelve trading days the whole of 1980's world trade --all the oil and goods and so forth that passed among all the countries in the world.

Why does it have to go through CHIPS? First, it is rather efficient if everybody everywhere in the world knows that there is only one payment system, only one location to which they have to make payments when doing transactions with one another. It is like having only one currency for doing different sorts of transactions instead of having to go through many payment systems. But the fundamental reason why everything goes through CHIPS instead of, for example, an alternative clearing system in London such as is being proposed, is that any payment system that involves settlements between banks over time, rather than instantaneously, involves out-payments sometimes preceding in-payments. The CHIPS system is settled on a two day basis. The amount that is transferred between banks in any one day is settled in Fed funds the following day. In the future, same-day settlement will be instituted but the principle remains.

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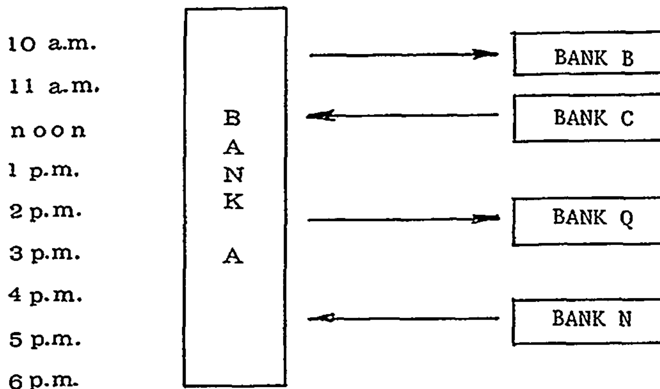

Exhibit 5: CHIPS INTRADAY SETTLEMENT RISK

Exhibit 5 indicates what happens on a typical trading day during which international payments go through the CHIPS system. They are not paid in real money yet. They are only paid in clearing-house funds, which is an understanding that real money will be paid the following day, or (when CHIPS moves to a same-day clearing system) later on the same day. This, however, takes time and Bank A, for example, may have various payments coming in and out during the day. At any one point, Bank A may make an out-payment in expectation that they will receive an offsetting in-payment later on because these two transactions already have been concluded. They are just waiting for the clearing system to take effect.

What would happen if, at any point before these transactions offset one another, somebody interrupts the payment system? Somebody closes down the system, or the computer breaks down, or they were expecting a payment from Bank C which is located in Iran and all of a sudden Bank C does not make the payment, or the central bank of that country closes down the bank, or something else goes wrong. In other words, the offsetting payment does not come in before the end of the clearing day. Then all these payments and settlements would have to be unwound. There would be a great deal of uncertainty as to who owed what to whom at that particular point. There would be concern about who was suspect, and to whom you could make out-payments prior to receiving offsetting in-payments. The whole system would slow down and a liquidity crisis could result. The reason CHIPS works so well is that people have confidence in it. If anything of this nature were to go wrong, there are twelve major U.S. banks that are members and therefore backers, essentially insurers of the CHIPS system; the Federal Reserve is assumed to be standing behind these banks. All these banks have access to the U.S. central bank.

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A similar system could be set up in London for dollar payments between banks but so far there has been an unwillingness on the part of any institution or set of institutions to make the investment and take the risks that would be involved in backing a system to assure all payees that they ultimately would get paid any transfer that was due them. Part of the reason for the reluctance is that it would be a dollar payment system in a sterling country. It would have to be backed up by sterling-based banks and ultimately by the Bank of England. This is largely why the international payment system goes through the U.S. and will continue to do so.

3. EFFECTS OF THE FREEZE

A. Deposits with U.S. Banks Abroad

Despite all the concern that was voiced in 1979 when the Iranian deposit freeze was first imposed, concern about the disruption that would result in the international dollar deposit and payment system, very little in fact occurred. The system has proved extraordinarily resilient. Even the fear that U.S. banks would lose deposits was ill-founded, as Exhibit 6 shows.

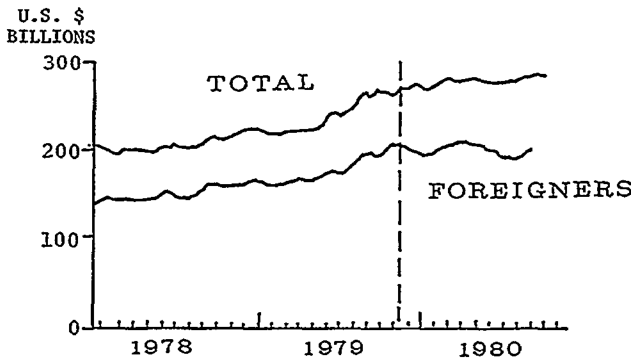

Exhibit 6: EURODOLLAR DEPOSITS IN U.S. BANKS

Source: FEDERAL RESERVE BULLETIN

Based on Federal Reserve data, this diagram indicates the total amount of deposits in U.S. banks abroad denominated in dollars; that total climbed through 1978 and 1979 at a quick pace and continued to climb in 1980. Of that total, the bulk was from nonresidents of the U.S. Those deposits dropped slightly after the freeze (indicated by the dotted line) but rebounded shortly thereafter. There has been no mass outflow of deposits from U.S. banks

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or from the U.S. dollar or Eurodollar market as a whole. The reason is simply that even if you have U.S. dollars in a bank abroad and you are subject to this transfer risk, you can protect yourself in various ways--for example, by having a clause in any deposit contract or an understanding even in unwritten contracts that the depositor has the option of receiving payment in another currency, should the original currency of denomination be frozen. However, this agreement will not be costless because if that were to happen, the banks themselves might be subject to the risk of having to pay out in another currency while the currency in which the deposit was made was frozen. Although one can obtain such protection, as with any other form of risk reduction, it is not going to come free. Banks will surely either protect themselves against the risk by stating their exemption from such obligations or, if they provide the option to pay in another currency, they will pay a lower interest rate or charge for that insurance in some fashion.

B. Application of the Freeze to Cover and Foreign Currency Accounts

MR. MUNDHEIM: Let me ask Bob Carswell to answer one question that flows from that very good explanation of Ian's. Ian's explanation certainly indicates that cover accounts in dollars would also be included in a U.S. government freeze. That is, a Eurodollar deposit in Barclay's Bank would also be caught. Why were those cover accounts specifically excepted by the regulations? Ian's other point was that if the deposit agreement had an alternative payments clause, that clause would likely free the deposit from the risk of being effectively frozen. Again, there was a general license for Iranian deposits in U.S. banks abroad denominated in currency other than dollars. Could you explain why those two situations were not ultimately subjected to the freeze?

MR. CARSWELL: There is some history that may not be publicly recorded, but during World War II the Treasury came up with a cover account theory. The theory was that any dollar transfer, wherever located, ultimately had to be done through what was known then as a cover account in the U.S. It was not really a cover account, but the way the transactions worked was known as the cover account theory. I believe a reference to this may have appeared in one lower court decision.

In subsequent blockings (the Chinese, North Korean, Vietnamese, and the Cuban blockings) the issue came up only peripherally, because there were no significant overseas dollar deposits by any of those countries, at least that anybody knew about, and hence, nobody ever really focused on this problem. From time to time an event did occur where an overseas dollar transaction popped up, and the Office of Foreign Assets Control of the Treasury did occasionally invoke the cover account theory to deal with it. For example, in one instance when the Vietnamese tried to make a dollar transfer, and the dollars had to come back to the U.S., Foreign Assets Control took some action.

In any event, the cover account theory was discussed in the Treasury during all those years but I am not aware of its having been really used. When the Iranian blocking came along, everybody recognized that all of a sudden we had something that was unique. U.S. banks had these huge deposits abroad, and if the freeze was going to mean anything, you had to block them. The question was how far you went with a theory that had very sparse legal background, that is, no court decisions that meant anything--and where there were practical limitations to its enforceability. We just had to make a very quick policy judgment on how far one could press the

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theory. The judgment was not to go for the full cover account theory and block overseas dollar accounts in foreign banks, thereby taking on foreign banks and their regulators in all the jurisdictions where dollar accounts were situated. At least, as far as U.S. banks were involved, we had them here anyway, and it was going to be less likely that they could protest. It was simply a practical judgment.

We decided not to include foreign currency accounts in the overseas branches of U.S. banks for the same practical reason. Again, the U.S. government can get to the U.S. banks because the U.S. banks are sitting here with their head offices. In theory we could have said to Chemical Bank in Paris, "Don't pay out the franc account that you have for the Bank Markazi." They would then have been subject to the excruciating problem of which regulator they should listen to--the French or the U.S. It seemed very clear that we were going to have nationalism problems of a high order if we tried to block the franc deposits. Hence, we decided not to do that either.

MR. NICHOLS: But you did. . . .

MR. CARSWELL: I am sorry. We did include them at first, but then within a week or so we reversed that decision because it was perfectly clear it was going to get us in a lot more trouble than the pressure it might put on the Iranians.

MR. MUNDHEIM: Well, in light of your explanation that there are practical difficulties in applying the freeze theory to what I will loosely characterize as cover accounts and to foreign currency accounts, one is then driven, John, to the question of why foreign depositors would not make all their dollar deposits through the branches of non-U.S. banks, since as a practical matter they would recognize that in the event of a freeze it is unlikely that the government would move to a cover account theory to catch those assets.

MR. HOFFMAN: I would suppose that the foreign depositors would be best qualified to answer that question. The evidence that Ian Giddy has pointed to has demonstrated that this was not the consequence that flowed from the Iranian freeze, although there was some speculation that there might be a movement in that direction. People did not, in fact, take the deposits out of the U.S. foreign branches and take them all across the street to National Westminster or Barclay's. The question is, why didn't they, in light of the fact that there was at least some demonstrable incremental risk attendant on keeping the deposits in a U.S. bank branch, rather than in a foreign bank.

Perhaps I should let Ian Giddy give you the real answers. But I want to begin by speculating a little bit. There is probably a combination of reasons. Certainly an American bank holds most of its earnings in dollars. Its assets are not primarily denominated in yen, for example. When you put money into a bank, you are anxious to get it back and to see your deposit backed up by assets that are predominantly in the currency of your deposit. I think that has to be the prime reason.

Ian Giddy pointed out in his remarks earlier that a U.S. bank has a direct means of access to the Fed that is not available to a foreign bank, and that presumably has some bearing on a decision to

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place deposits in U.S. Banks. By the same token, someone who wanted to maintain franc accounts would prefer a French bank over a German bank.

MR. MUNDHEIM: Alec, as a banker what are your thoughts on the question?

MR. VAGLIANO: As Professor Giddy said, there are four different risks here: the condition of the bank, the central bank backing, the host country's political risk, and the transfer risk. Most people, looking at the present situation from their own point of view, see the Iranian situation as a very special one in which there was an outrageous act by the Iranian government. They do not expect their own government (I am speaking now of the foreign depositors) to put them in that kind of a situation; so it is clearly a risk that is very much discounted at the present time.

Still, it is fair to say that there could be circumstances under which this is seen as a precedent. A political situation could arise where people might remember the Iranian occasion, and the risk would then become more relevant and more immediate, and it could result in a different decision.

MR. CARSWELL: I think I should say that from where we sat in the government, we would agree with that, and we were at great pains to say that all the way through. The Iran blocking was a response to a particularly outrageous event. It was not, at least as far as we were concerned, to be regarded as a precedent. Indeed, in the final settlement we did everything we could (and it worked out successfully) to unwind the extraterritorial effect of the whole thing simultaneously with the release of the hostages. So, there is not even a vestige of the extraterritorial blocking left and, again, that was not an accidental policy course.

C. Alternative Payments Systems

MR. MUNDHEIM: Is this alternative payment procedure that you have mentioned, Ian, a practice which is beginning to gain currency?

MR. GIDDY: There are other reasons besides the transfer risk for establishing an alternative payments mechanism. Indeed, I have heard a number of London bankers complain that they have to go through New York and pay the transatlantic communications cost, and that they would like to have a payment system in London. It seems to me that the fact that there are good economic reasons for people to want the payment system in London or elsewhere and the fact that this has not emerged, despite several proposals and studies looking into this, is evidence that the transfer risk has not provided any great incentive to establish a new system.

There has been absolutely no move towards realistic setting up of such a system, although it is true that some payments are made between banks in London for securities purposes, for retail transactions, and for claims among insurance companies.

Bob, could I take the opportunity to reply to one of the questions sent up from the audience?

MR. MUNDHEIM: Certainly.

MR. GIDDY: There is a question that has been asked of me

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that bears directly on this. The question is, if Bank Markazi asked Citibank, London to transfer its credit balance on Citibank, London's books to the account of Barclay's Bank, might this transfer of credit from one account to another in Citibank, London be accomplished without a transfer through New York? In other words, if two entities both have an account in Citibank, London, could London just offset one against the other and not require any transfer through accounts in banks in New York? That is correct: in principle, offsetting payments could be made in London within the same bank. From the evidence that I have seen in relation to the deposit freeze case, that sort of thing is done very rarely but it is done. So, in principle it seems to me that a transfer within a branch to another account within the branch could be made by Citibank, London on behalf of Markazi.

MR. NICHOLS: I would like to follow up with one additional comment. I think it is right, as Ian points out, that as a practical matter, this is something that can be done. There is a legal issue involved, however, that I think becomes quite significant when you consider the amounts that you are talking about in connection with these central bank accounts.

If you have an American bank branch that has a very large deposit from Customer A and it is very happy to do business with Customer A in that magnitude, it may not be so happy to do business with Customer B in the same kind of magnitude, for all sorts of reasons: one being the future relations with Customer B and whether it is going to be a stable account and all those sorts of things. So I think there is a very serious legal question whether Customer A can direct the bank to establish a similar account for Customer B. I do not think there is anything in the implied contract of deposit between the bank and Customer A requiring the bank to do business with Customer B on a similar basis. Such a requirement would be the consequence of that kind of transfer directed by Customer A, unless, of course, Customer B has an account.

MR. MUNDHEIM: Our discussion here will not decide the issue that the British court would have had to decide. We have heard explanations of what the defense would have been; but since we do not know what the answer of the British court would be, we are left with a question rather than an answer. However, it is an issue that depositors and others who deal with the dollar system have to bear in mind, and I think all we want to do is to recognize that it is an open issue and to understand the basis of the U.S. position and the bank defense.

D. Foreign Currency Accounts

MR. HOFFMAN: I would like to add one other comment that bears on a couple of things that some of the others on the panel have said with regard to foreign currency accounts in U.S. banks. It has been pointed out that almost immediately after the freeze a license was issued which permitted transfers of foreign currency accounts. These were no longer blocked, for reasons Bob Carswell pointed out. One of the consequences of that license was the establishment of a fact that bears on the validity of the legal theory of the freeze defense in London.

The freeze defense, remember, was predicated on the fact that dollars always remain in the U.S. All dollar transfers must be done in the U.S. By the same token, guilders are currency in the Nether-

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lands, not in England or in Japan. If you do a transfer of a guilder account, another Euro-currency, it has to go through the Netherlands. Soon after the freeze had been imposed and the license for these foreign currency transactions had been issued, such a transfer was made by Bank Markazi, which had a guilder account with a European branch of an American bank. Markazi directed the transfer to be made in the bank in the Netherlands, recognizing the fact that such a transfer must go through the Netherlands because that was the local currency of deposit.

MR. MUNDHEIM: Robert, you had a comment.

MR. CARSWELL: Let me just close, or try to close, a circle. I think you ought to remember, in assessing the transfer risk issue, that when the U.N. imposed sanctions on Rhodesia some years ago, in the early 1970s, it included the freezing of accounts in its resolutions. The U.K. at that point adopted its own freeze measures in the U.K. and, in fact, froze Rhodesian pound accounts in the U.K. on a basis parallel to what the U.S. and other countries did. So, your transfer risk is not solely an Iranian experience. It does come up, has come up from time to time, in other jurisdictions. If you start thinking of what other bank you could go to, to be assured of no problems, you may have to recognize that there is no sure escape. I do not suppose anybody can predict where the next tensions will come, and in what currency and with what relationships they will be confronted.

MR. MUNDHEIM: Let me ask one additional question in light of that particular observation. If someone has a dollar deposit with a London branch of a U.S. bank and the British freeze payments, can that depositor come to New York and say, "I deposited some dollars with your bank and now I would like them back."

MR. NICHOLS: No.

MR. MUNDHEIM: Because. . .

MR. HOFFMAN: No--unless it is specifically spelled out, which it may be. I believe in many instances if the deposit is reflected by a certificate of deposit, a CD, the terms may be typed or written right on the document. If not, it is an implied term of the deposit contract that is subject to the laws of the country in which the branch is located. Without taking up a lot of time, I am convinced that such a position is not inconsistent with the elaboration of the argument we made. Although some people may be willing to debate it on another occasion, I think that it is widely recognized that if you maintain a deposit on the books of a branch in London, you are subjecting yourself to regulation and control by the U.K. Mr. Nichols, would you disagree?

MR. NICHOLS: No, I do not think I would disagree. The Fed thinks there is a difference between Eurodollars and domestic dollars, and it treats them differently for a number of regulatory purposes. Obviously the theory is that the Eurodollar market is less attractive to American depositors because there is a different level of risk. In other words, everybody has always assumed, or should have assumed (although I must say I do not think bank deposit contracts are written as clearly on this point as they might be) that if you have U.S. dollars on deposit in Nassau, and the Bahamian government chooses to impose a system that says, "You can get paid

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the dollars in Nassau but you cannot get them out" you will be unable to recover against the head office in the U.S. I have always assumed that everybody understood that this kind of a freeze was a possibility. Now, the Bahamians are presumably cutting their own throats in the process, so nobody thinks it is very likely. But there have been times, I believe, when dollar deposits in the Bahamas have commanded rates different from those on dollar deposits in London, because it is assumed that there is a different risk as between the Bahamas and the U.K.

MR. VAGLIANO: That is right. I think that in the early period of the Eurodollar market, for example, there were some of the more conservative Swiss depositors that hesitated about putting their Euro-deposits in London because of the British risk.

MR. MUNDHEIM: Fred, you had a comment?

MR. HELDRING: I have no comment on the legality, but one on the matter of practice. We have a branch in Nassau and were one of the first to have one. We have always thought that if something happened, we would just transfer our books back to the U.S. and pay. It is a branch and we pay.

MR. NICHOLS: One New York bank is defending pretty vigorously a suit for dollar deposits made in its Saigon office, if I am not mistaken. You also have the fact that if you tell your customer that you are prepared to pay him in Philadelphia, you are going to have to keep reserves against the deposit.

There is a very specific Fed interpretation of Regulation D, which says that if an American bank guarantees repayment at its head office of a foreign office deposit, then that becomes a U.S. deposit for Regulation D reserve purposes--and I would assume probably also for Regulation Q purposes if there were a Q ceiling applicable.

NOTES

[1] Exec. Order No. 12170, 44 Fed. Reg. 65729 (1979).

[2] White House Press Release, 15 Weekly Comp. of Pres. Doc. 2117 (Nov. 14, 1979).

[3] *See* 31 C.F.R. pts. 500, 515 (1980).

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