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Getting Down to Basics: Strengthening Financial Systems in Developing Countries

John W. Head*

I. INTRODUCTION

My perspective on the topic of this roundtable symposium, "International Financial Services: Diverse Approaches in a Globalized Environment," differs importantly from those of several of the other participants. I wish to highlight this difference at the outset because it bears on the kind of contribution I wish to make to the symposium. My experience in international financial services has come neither from the private sector—as an executive with an international commercial bank, for example—nor from a regulatory angle per se, and I would be the first to admit that there is a great deal I do not know when it comes to banking practice and regulation. Instead, the experience that I draw on for purposes of this symposium is systemic and legislative in character. For several years, I have worked with government officials in various less developed countries ("LDCs") to improve their respective banking and central banking laws so that the banking practice and regulation would more effectively serve the interests of those countries' people. I have worked in such countries as Mongolia, Namibia, Jordan, and three of the former Soviet republics in Central Asia. My work is typically conducted under the auspices of one or another of the various international organizations that offer assistance to LDCs to strengthen their financial systems. The organizations I have primarily worked under, for these purposes, are the Asian Development Bank ("ADB") and the International Monetary Fund ("IMF").[1]

Professor Malloy kindly invited me to offer some observations that have emerged from my experience in this line of work. I understand that he has had some similar experience himself, and no doubt some of the other participants in this symposium have also had such experience, or are at least generally aware of the nature of such work.

It is not rocket science. In many countries, the legal framework in which the financial sector operates is vague, outdated, incomplete, or confused. Therefore, the advice that I have offered in the countries where I have worked may seem elementary or even simplistic to someone familiar with the intricacies of modern

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* Professor of Law, University of Kansas. I wish to thank my fellow participants in the November 2004 Symposium on International Financial Services, hosted by the McGeorge School of Law, for their interest in and suggestions about this article, and Ms. Ashley Brown for her dedicated research assistance. Support from the University of Kansas General Research Fund is also gratefully acknowledged.

1. In addition to serving as a legal adviser under the auspices of these two organizations, I have also served, before entering academics, as legal counselor on the staff of each of them. Moreover, I have assisted the IMF in the preparation of teaching materials for use in training banking and central banking personnel in various countries. The observations I make in this article are my own and do not necessarily reflect the views of either the ADB or the IMF.

banking practice and regulation in countries with mature, sophisticated financial systems. Most people in the world, however, do not live in such countries and are not served by giant financial institutions. Instead, most people live in LDCs and deal mainly with "corner banks"—small financial institutions that operate under national banking laws, as administered by national or local government officials. When those banking laws and those government officials prove inadequate to the task, the result can be financial crisis that brings anguish to the shop owner in Monterrey, the pensioner in St. Petersburg, and the construction worker in Surabaya. Moreover, in today's integrated global economy, we have seen plenty of examples, including the Asian financial crisis of the late 1990s, of how a weak financial system in one country can bring economic devastation not only to the people of that country but also to the people of many other countries as well, even to the point of threatening the international economic system as a whole.

In my view, then, the financial security of many individuals, as well as the overall stability of our global financial system, depend in large measure on getting all or most countries—especially LDCs that have weak financial systems—to adopt certain principles and practices, though they may seem elementary or simplistic. Hence, the theme of my contribution to this symposium: "Getting Down to Basics." I wish to emphasize some of the basic points that warrant the closest attention by national lawmakers and policy-makers, in those LDCs striving to strengthen their financial systems to withstand the rigors of an increasingly globalized economy. I hasten to point out, however, that my observations do not apply only to LDCs and certainly are not intended to constitute a sermon to LDC officials. After all, as the U.S. savings-and-loan crisis of the 1980s illustrates, sophisticated national financial systems are by no means immune to debacle. Instead, when any country disregards certain foundational principles and practices, it puts itself, its people, and its neighbors at risk. Accordingly, I hope my contribution to this symposium, while drawing on my experience in LDCs, might be regarded as a reminder of basic precepts on which the financial systems of all countries—not just LDCs—should rest. Expressed differently: In the face of a global financial system that constantly gains in complexity and sophistication, I wish to urge that we keep certain elementary principles and practices in mind, and work for their universal application.

In the remainder of this article I summarize and explain what I consider to be the most important of those principles and practices. They fall into three categories: central bank independence, modern international banking standards, and rules and procedures for handling troubled or insolvent banks. My thesis, in a nutshell, is this: (i) a strong national financial system will have a central bank that is independent from short-term political pressures, although ultimately accountable to political authorities; (ii) commercial banks should be required, under laws enforced by the government agency responsible for supervising banks (which I believe should typically be the central bank), to observe international standards on making loans, maintaining capital, reporting operations, and the like; and (iii) banks that fail should be restructured or liquidated under strict and

special "exit strategy" rules that protect depositors and penalize managers and owners.

I have offered views of this sort before, in the course of some other articles and a book,[2] and I would refer the interested reader to those other publications for further details and for a more comprehensive citation to source materials. Indeed, with the kind permission of the editors of *The Transnational Lawyer*, I have prepared this article less in the form of a traditional law journal article and more in the form of a lightly-footnoted essay, confident in my assumption that there is little need to repeat my earlier citation to authority for most of the propositions I make here.

On the other hand, I am not merely repeating in this article what I have said earlier, for some of the observations I make here reflect my recent experience in yet another LDC—the Republic of Maldives, a small island nation located off the southwest coast of India—as well as my recent review of several other banking and central banking laws in developing countries (or countries in economic transition). I draw on those sources in an effort to illustrate several points regarding the importance of assuring central bank independence, insisting on international standards, and facilitating the smooth exit of failed banks from the system.

II. CENTRAL BANK INDEPENDENCE[3]

What is meant by central bank independence? The Chairman of the U.S. Federal Reserve Board, Alan Greenspan, described it this way: "central banks need to be independent, meaning that their monetary policy decisions are not subject to the dictates of political authorities."[4] That is the nucleus of central bank

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2. *See generally* John W. Head, *Lessons from the Asian Financial Crisis: The Role of the IMF and the United States*, 7 KAN. J. L. & PUB. POL'Y 70 (1998) [hereinafter Head-1998]; John W. Head, *Global Implications of the Asian Financial Crisis: Banking, Economic Integration, and Crisis Management in the New Century*, 25 WM. MITCHELL L. REV 939 (1999) [hereinafter Head-1999]; ROBERT LEE RAMSEY & JOHN W. HEAD, PREVENTING FINANCIAL CHAOS: AN INTERNATIONAL GUIDE TO LEGAL RULES AND OPERATIONAL PROCEDURES FOR HANDLING INSOLVENT BANKS (2000) [hereinafter RAMSEY & HEAD].

3. For citations to some of the rich literature that has developed on this subject, see RAMSEY & HEAD, *supra* note 2, at 3 n.2. For some contributions to the literature in just the last three or four years, see Charles Freedman, *Central Bank Independence*, *in* CENTRAL BANKING, MONETARY THEORY AND PRACTICE 90 (Paul Mizen ed. 2003), at 90-110 (observing that one of "the most interesting and striking developments in central banking over the latter part of the twentieth century" has been the spread of central bank independence); ALAN S. BLINDER, THE QUIET REVOLUTION: CENTRAL BANKING GOES MODERN 65-74 (2004) (suggesting that attention to central bank independence from politics, which has been endorsed widely and reflected in legislative changes around the world, has eclipsed consideration of another form of central bank independence—independence from the financial markets); Eli M. Salzberger & Stefan Voigt, *On Constitutional Processes and the Delegation of Power, with Special Emphasis on Israel and Central and Eastern Europe*, THEORETICAL INQUIRIES L. 207, 238-47 (2002) (offering a quantified assessment of central bank independence in Israel and certain Eastern and Central European countries).

4. *Implications of the Asian Financial Crisis: Before the House Comm. on Banking & Financial Services*, 105th Cong., 2d Sess. (1998), *available at* 1998 WL 37819 (statement by Alan Greenspan, Chairman of Board of Governors of the U.S. Federal Reserve System, Jan. 30, 1998).

independence, although it has numerous other elements as well that reflect what a modern central bank is and what it is supposed to do. Accordingly, in order to explore central bank independence I turn first to a thumbnail sketch of a modern central bank.[5]

Typically, a central bank is a legal entity, created by statute, having its own capital, wholly owned by the government, but operated by a board of directors responsible for running the central bank in a commercially prudent manner, while carrying out the functions entrusted to it. Those functions can usually be divided into two categories: one primary function and a handful of secondary functions.

The primary function is, or should be, to promote price stability. High rates of inflation—or, put differently, rapid drops in the purchasing power of the currency—can rob people of their savings, make their business dealings risky and difficult, and undercut their economic life generally. Countless times, runaway inflation has drawn countries into economic misery or even political chaos. Hence, in recent years, a consensus has emerged that a central bank should have price stability as its central objective.[6]

In order to pursue that objective of price stability, central banks around the world use a standard set of "instruments of monetary policy" designed to influence the amount of money available in the economy. Some of the most important such "instruments of monetary policy" include reserve requirements (mandating that commercial banks set aside a certain proportion of the amounts they hold in deposits), refinancing policy (setting the terms at which the central bank will provide credit of various types to commercial banks), open market operations (the buying and selling by the central bank itself of securities on the open market), and foreign exchange interventions (the buying and selling by the central bank itself of currencies, so as to affect the value of the country's own currency against those of foreign countries).

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5. In giving the following account of a typical "modern central bank," I draw from my study of central bank statutes from numerous countries, most of them enacted or taking effect since 1990. I do not draw substantially on U.S. law and practice for these purposes, since the functions typically assigned to central banks in modern legislation are, in this country, scattered across a number of institutions, including the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and state banking officials. For a reference to this multiplicity of agencies, and the coordination among them, see WILLIAM A. LOVETT, BANKING AND FINANCIAL INSTITUTIONS LAW IN A NUTSHELL 120 (2001). For further details on the functions of a typical modern central bank, see Head-1998, *supra* note 2, at 86, and RAMSEY AND HEAD, *supra* note 2, at 6-7.

6. For an economic analysis of the importance of price stability, see MAXWELL J. FRY ET AL., CENTRAL BANKING IN DEVELOPING COUNTRIES 13-16 (1996). Those authors explain that a growing dislike of inflation has led to the conclusion "that the objective of a central bank must be to achieve price stability." *Id.* at 16. They also note that some modern central bank statutes reflect the primacy of price stability as an aim of the central bank, and they surmise that even more statutes would do so if they were to be revised today. *See id.* at 17, 19. In their conclusion, they "detect a general acceptance of the benefits of price stability as the primary central bank objective . . . ." *Id.* at 113. For another reference to the "growing consensus in support of price stability as the prime objective of a central bank," see ANAND CHANDAVARKAR, CENTRAL BANKING IN DEVELOPING COUNTRIES 5 (1996).

In addition to promoting price stability—that is, the sustained value of a country's currency over time—a central bank typically has a cluster of five other main functions. First, the central bank usually serves as banker, agent, and adviser of the government. In this role, the central bank is involved in preparing the government's budget, serving as a depository for government funds (although the government should also be permitted to keep accounts with commercial financial institutions), and receiving and disbursing government moneys. As part of this function, the central bank should also be in a position to grant temporary advances (loans) to the government, but such advances should be made subject to clearly specified limits and should not be on preferential terms. The central bank should be entrusted with the issuance and management of government securities and be consulted on foreign borrowings of the government and government enterprises. Additionally, the central bank should serve as agent for the government in various other ways as well, including acting as fiscal agent for dealing with international organizations.

A second additional function of a typical central bank focuses on foreign exchange matters. The central bank usually serves as the central repository of the government's international reserves, including gold, other precious metals, and the other countries' currencies owned by the government, and it is responsible for managing those reserves prudently. Such international reserves are valuable to the country, of course, because they help pay for imported goods and help support the value of the country's own currency. In many cases, the central bank also bears responsibility for foreign exchange policy more generally, including the establishment and management of the country's exchange system—that is, the mechanism by which the external value of the currency is determined. The central bank's role in this area is limited, of course, where, as in some countries, the government adopts the policy of "pegging" the value of the country's currency to the value of one or several foreign currencies.

Third, the central bank provides various financial services to the commercial banks in the country. In most countries, the central bank sits at the top of a "two-tier" banking system, with private-sector commercial banks occupying the lower tie. It holds accounts for most or all of the commercial banks in the country. For those banks, the central bank provides "lender of last resort" services such as purchase, sale, and discount of certain types of commercial paper and government securities, and the granting of advances, subject to certain specified limitations that should be strictly observed. The central bank typically has a supervisory role in the payments system (the mechanism by which banks make payment on orders of their customers) and the system of inter-bank settlements (the mechanism by which banks can settle up accounts among themselves periodically).

A fourth function of a typical central bank (again, beyond its mission of price stability) is bank supervision. In many countries, the central bank is entrusted with the licensing and regulation of banks—and perhaps also other financial institutions that do not fall within the usual definition of banks (so-called "non-banking financial institutions" or "NBFIs")[7]—in order to promote a healthy financial system in the country. This supervision does not amount to instructing or influencing banks as to what loans to make to whom. Instead, banking supervision entails imposing and enforcing rules of the type I shall summarize below in part III of this article, with the overall aim of guarding against dishonesty and incompetence in the operation of banks and promoting prudent management of the bank's resources, including most importantly the funds placed with those banks by depositors. In some countries the responsibility for bank supervision rests with a government agency other than the central bank, but in my view the best place for such authority in most LDCs is the central bank.[8]

A last function of the typical modern central bank is to issue the nation's currency. This entails authority to direct the minting of coins and printing of notes, as well as the authority to handle related matters such as regulating the transportation and distribution of those notes and coins, the surrender and exchange of torn or worn-out notes, and certain aspects of the measures to prevent or punish counterfeiting and similar criminal activity.

That is all. According to the predominant thinking today, a modern central bank has those functions listed above, along with some very closely related responsibilities, but no more.[9] The legislation in many countries limits the role of

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7. In simplest form, the definition of a bank typically includes two elements: (i) taking deposits from the public and (ii) using the deposits so taken in making loans to other persons. Many entities involved in financial transactions meet only one or the other (but not both) of these elements. Whether such non-bank financial institutions (NBFIs) should be subjected to licensing and supervision by the central bank depends on a variety of circumstances that differ from one country to the next. These circumstances include the capacity of the central bank to undertake such licensing and supervision functions and the risk that might be posed to the country's economy if such NBFIs are not regulated by the central bank or any other governmental entity.

8. Rather than belabor this point here, I shall merely: (i) acknowledge that there are differing views on the issue of where bank supervision authority is best placed; and (ii) point out that one of the preeminent authorities on central banking recently explained why, in his view, bank supervision authority in developing countries should be placed with central banks. Charles Goodhart, *Whither Central Banking*, *in* EVOLUTION AND PROCEDURES IN CENTRAL BANKING 76, 76-78 (David E. Altig & Bruce D. Smith eds., 2003). For an explanation of my views, see RAMSEY & HEAD, *supra* note 2, at 7-8. For another assessment of this issue, highlighting certain benefits to be derived by lodging bank supervision authority with the central bank, see generally Joe Peek at al., *Is Bank Supervision Central to Central Banking?*, 114 Q. J. ECON. 629, 629-53 (1999). *See also* Maria Laura Patino, *Lessons of the Financial Crisis in Ecuador 1999*, 7 L. & BUS. REV. AM. 589, 616-17 (2001) (summarizing benefits of entrusting banking supervision responsibilities to the central bank in LDCs); Joseph J. Norton, *The Modern Genre of Infrastructural Law Reform: The Legal and Practical Realities—The Case of Banking Reform in Thailand*, 55 SMU L. REV. 235, 256-57 (2002) (same).

9. By making such a definitive statement, I do not mean to suggest that there are simply no disputes as to what the objectives of central banks should be. As one authority pointed out, "[t]he increased incidence of crises in the era of financial globalization forces us to ask ourselves: Should financial stability be an explicit central bank objective?" Eduardo Aninat, *Foreword to* CHALLENGES TO CENTRAL BANKING FROM GLOBALIZED FINANCIAL SYSTEMS v (Piero C. Ugolini, Andrea Schaechter, and Mark R. Stone, eds. 2003). That author goes on to raise the "practical institutional question" that I mentioned in passing above—whether banks should be supervised by a specialized agency or by the central bank. *Id.*

the central bank to those functions, all of which are related to money and currency, so that the central bank will not have its role, or its integrity, diluted by getting involved in too many activities, particularly activities that involve political influence. Why should political influence be avoided? Because political influence interferes with the ability of a central bank to carry out the several functions I have summarized above. This is especially true with respect to the primary aim of price stability.[10] Many studies, though not all, have suggested that greater central bank independence yields more monetary and price stability.[11]

What, then, is central bank independence and how is it provided for—or perhaps I should say how is it facilitated or encouraged—as a legal or statutory matter?[12] As indicated above, one form of central bank independence is a strong measure of financial separateness from the executive branch of a country's government, so that the government cannot simply use the resources of the central bank as its treasury to meet short-term budgetary needs. Expressed differently, although one of the functions of a modern central bank is to serve as banker, agent, and adviser to the government, the central bank is not to be a source of easy money for the government. To this end, many central bank statutes place limits on central bank credit to the government—prescribing, for example, that such central bank lending to the government: (i) be limited to a specified ceiling amount (sometimes expressed as a proportion of annual government revenues); (ii) be limited in duration (for example, to thirty or ninety days); (iii) be collateralized with adequate security; and (iv) carry market-based interest rates.

To illustrate the importance of such provisions, let us consider their absence in the Maldives Monetary Authority Act 1981, a statute I was asked in 2003 to help the Maldivian authorities update. The Maldives Monetary Authority

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10. As one authority on central banking has expressed it, several factors tend to "lead governments to be willing to take more risks in the direction of stimulating the economy than would be the case for central banks;" and "it has been the desire to avoid this tendency to be overly stimulative that has caused governments to give central banks increased independence in the conduct of monetary policy." Freedman, *supra* note 3, at 99.

11. For a citation to some of the literature on this point, see Head-1998, *supra* note 2, at 97 n.110. Among the most compelling of these is C.A.E. GOODHART, THE CENTRAL BANK AND THE FINANCIAL SYSTEM 63 (1995) (noting that "econometric/statistical tests have shown that countries with more independent central banks have had generally lower inflation rates"). For two recent studies confirming the strong correlation between central independence and low inflation, see Salzberger & Voigt, *supra* note 3, at 238-47, and Harold J. Brumm, *Inflation and Central Bank Independence: Conventional Wisdom Redux*, 32 J. MONEY, CREDIT & BANKING 807 (2000) (explaining that careful empirical analysis shows a strong negative correlation between inflation and central bank independence). However, some authors question the purported relationship between central bank independence and economic performance. For a recent work emphasizing the importance of personalities, political structure, and other influences as possible contributors to central bank performance, see generally PIERRE L. SIKLOS, THE CHANGING FACE OF CENTRAL BANKING: EVOLUTIONARY TRENDS SINCE WORLD WAR II (2002).

12. No one could reasonably argue that legislative provisions, in and of themselves, can be effective in bringing about the conditions they purport to create. As one author has expressed it, "legislation alone does not a central bank make." SIKLOS, *supra* note 11, at 27. However, my own view, apparently shared by many others engaged in helping strengthen legal frameworks around the world in the financial sector, is that legislative provisions do matter a great deal and can be an extremely strong influence for change.

("MMA") serves as the central bank of the Republic of Maldives. Starting early in 2003, MMA officials undertook the task of revising the statutory charter under which the institution had operated for over two decades. Among the provisions that came under scrutiny in this process were paragraphs (f) and (h) of Article 22, which read as follows:

> 22. The Authority may:
>
> . . . (f) buy, sell, invest, or deal in treasury bills and other securities issued or guaranteed by the Government;
>
> . . . (h) make temporary advances to the Government as may be agreed.[13]

Such broad provisions as these—which, in my experience, are not at all unusual—could serve as an invitation to the government to obtain easy credit from the central bank (in this case the MMA) either directly under the authority of paragraph (h) or indirectly by pressuring the central bank to use its paragraph (f) authority to purchase securities issued by the government to finance a project or to cover budgetary shortfalls. By contrast, placing strict statutory limitations on such credit operations would enhance the independence of the central bank.

For example, paragraph (h) could be made subject to such limitations as these:

- advances made by the MMA to the government are to have a maximum maturity of ninety days and not be extended on a revolving basis;
- the amounts of such advances, combined with all other credit extended by the MMA to the government, are not to exceed ten percent of the annual average of the government's ordinary revenue for the preceding three financial years;
- such advances are to be certificated by debt securities that bear interest at market-related rates and have maturities corresponding to the maturities of the loans that they certificate;
- such advances are to be disbursed and denominated only in local currency; and
- such advances are to be made according to terms set forth in a written loan agreement executed between the Government and the MMA.

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13. Maldives Monetary Authority Act (1981), in approved translation as made available by the MMA, art. 22, *at* http://www.mma.gov.mv/laws/MMAACT.pdf [hereinafter "MMA Act"].

Similar limitations could be placed on the terms of paragraph (f), by making the amount of any purchases by the central bank of government securities subject to the ten-percent-of-revenue ceiling referred to above, and by providing that any such purchases of government securities are not to be made upon the original issuance of those securities but instead are to be carried out only as part of the central bank's open market operations or in connection with its extension of credit to banks.

Some limitations of this nature appear in the central banking law of Kyrgyzstan, another country in which I have worked on banking legislation. As reflected in the collection of banking laws maintained by the Central Banks Center sponsored by the New York University School of Law,[14] the central banking law of Kyrgyzstan provides that the central bank "may grant short-term credits on general terms for a period of no longer than 6 months to [the government] for use in covering the gap between current budget revenues and expenditures [but the indebtedness from] such credits must not exceed 5% of the amount of the gross domestic product of [the country]."[15] Likewise, some limitations on central bank lending to the government appear in the central banking law of Malaysia. As reflected in the version posted by the Central Banks Center, central banking law of Malaysia provides that the central bank "may grant temporary advances" to the government "at such rate or rates of interest as the Bank may determine" in order to cover temporary government budget gaps, but the total amount of such advances outstanding "shall not at any time exceed twelve and a half per centum of the estimated receipts of Malaysia" as shown in official government budget documents, and all such advances must be repaid "not more than three months after the end of the Government's financial year in which they are granted."[16]

A curious provision on central bank lending to the government appears in the central banking law of the Russian Federation. On the one hand, the statute states that "[t]he Bank of Russia shall not be entitled to extend loans to the Russian Federation Government to finance the federal budget deficit [or to] buy [its] securities at their primary placement," but then it undercuts that prohibition by

14. According to its website—http://www.law.nyu.edu/centralbankscenter—the Central Banks Center was established to study the nature and operations of central banks, and it disseminates information regarding central banks around the world. That information includes a documents collection that features (among other things) central banking statutes and general banking laws from numerous countries. I know from experience how difficult it can be to establish the authenticity of legislation in some countries, or to be confident that a particular version of legislation is up to date in reflecting all recent amendments, or to determine the accuracy or status of a particular translation. If my purpose in this article were to offer specific criticisms or analyses of particular statutes, it would be necessary to suffer through those difficulties. However, that is not my purpose. Instead, my reference here to banking legislation from various countries is intended to be merely illustrative; hence, I have not attempted to prove the precise authenticity, status, or translation of those laws.

15. Law on the National Bank of Kyrgyzstan, art. 10(1), *at* http://www.law.nyu.edu/central bankscenter/texts/Banking%20Law%20of%20Kyrgyzstan.html (last visited Oct. 12, 2004).

16. Central Bank of Malaysia Act (1958), as revised in 1994, §33, *at* www.law.nyu.edu/centralbank scenter/texts/Malaysia-Central%20Bank%20Act%20519.html.

the words "except for those cases stipulated by the federal budget law."[17] Such a clause seems to reduce the central bank's insulation against political pressure to serve as a treasury for the government.

I shall offer a second example of central bank independence by examining another of the functions often assigned to a modern central bank: banking supervision. The Maldives Monetary Authority Act 1981 contains very skimpy provisions in this regard, authorizing the MMA to carry out inspections of commercial banks and their books, and to impose minimum reserve requirements on banks, but little else. In contrast, a more comprehensive statutory framework would authorize the central bank to carry out the full range of banking supervision activities that I shall explain more in part III of this article. These include imposing and enforcing: (i) reporting requirements that mandate regular reports to be submitted by commercial banks to the central bank; (ii) single-borrower ceilings to limit exposure; (iii) insider lending limitations to prevent bank resources to be simply disbursed to owners or directors; and (iv) capital adequacy requirements to ensure a sound operating base.[18]

The central banking law for the Russian Federation also contains provisions of this nature. That statute provides explicitly that "[t]he Bank of Russia shall be the body of banking regulation and banking supervision . . . [and] shall conduct constant supervision over the observance by credit institutions and banking groups of banking legislation"[19] and then enumerates several specific types of norms the central bank can prescribe, including capital adequacy requirements, single-borrower ceilings, insider-lending limits, and the like.[20] Similarly, the Banking Law of Cyprus provides explicitly that "[t]he Central Bank is responsible for the supervision of banks in order to ensure the orderly functioning of the banking system."[21] It also specifies numerous aspects of that supervisory authority, including very strong and explicit enforcement powers—a matter that I shall return to later in this article.

Let me offer a third example of central bank independence. In my view, some of the most important provisions in central banking laws—indeed, the ones that depend most on the central bank's independence—are those relating to monetary policy and price stability. In too many cases a central bank statute fails

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17. Federal Law on the Central Bank of the Russian Federation (Bank of Russia) (as passed by the State Duma June 27, 2002 and signed by President Putin July 10, 2002), art. 22, *at* http://www.cbr.ru/eng/today/status_functions/print.asp?file=law_e.htm [hereinafter Russian Central Banking Law].

18. In some cases, provisions of the kinds I have enumerated here could be included in a commercial banking act (often called a "financial institutions" law) instead of the central bank legislation; but in that case the central bank legislation would still need to include adequate cross-references to the other legislation to make clear the central bank's supervisory authority.

19. Russian Central Banking Law, *supra* note 17, art. 56. That same article goes on to explain that "[t]he principle [*sic*] objectives of banking regulation and banking supervision shall be to maintain the stability of the Russian banking system and protect the interests of depositors and creditors." *Id.*

20. *Id.* art. 62.

21. Banking Law (No. 66(1) of 1997), art. 26(1), *at* http://www.centralbank.gov.cy/media/pdf/BCLWE_BANKINGLAW.pdf [hereinafter Cyprus Banking Law].

to identify price stability (or maintaining the value of the national currency) as the institution's primary purpose, or fails to place responsibility for monetary policy squarely on the shoulders of the central bank. The Maldives Monetary Authority Act 1981 suffered from both of these defects.[22] In my experience, many other central banking laws are also deficient in this regard. Even if they identify price stability as an important central bank objective, they often dilute that point by noting too many other aims and functions.

In Russia, for example, the central banking law clearly identifies as a purpose of the Bank of Russia "to protect the ruble and ensure its stability,"[23] but then calls on the central bank to "fulfil other functions in compliance with federal laws."[24] It also provides for central bank participation in numerous state-owned and foreign financial institutions,[25] raising the risk that the central bank's attention to price stability could be distracted. Similarly, the central banking law in Venezuela might be sending mixed messages by providing that the role of the central bank is not only "to create and maintain monetary, credit and exchange conditions that encourage the stability of the currency,"[26] but also to "foster economic equilibrium and promote the ordered development of the economy."[27]

In contrast, a strong central bank statute clearly specifies that the primary and overriding objective of the central bank is to promote price stability in the country, and sets forth the instruments of monetary authority available to the central bank in pursuing the monetary policy it establishes.[28] In some countries—most famously New Zealand—the central banking law makes the central bank's responsibility for monetary policy, and indeed for hitting previously-agreed-upon monetary targets, quite clear.[29]

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22. *See, e.g.*, MMA Act, *supra* note 13, art. 4 (lacking an explicit reference to price stability, and failing to identify the stability of the Maldivian currency as the MMA's primary aim). The Maldives has a "pegged" currency, in that it has for many years maintained the value of the national currency in relation to the U.S. dollar (although the precise exchange rate has been changed some through the years, resulting in gradual devaluation of the Maldivian currency). In such circumstances, a central bank cannot manage monetary policy per se with autonomy but instead can usually only support the established exchange rate of the national currency. However, this was not made very clear in the Maldives Monetary Authority Act 1981. *See id.*, arts. 4 (referring to the MMA's responsibility to "promote . . . the stability of Maldivian currency" but without a reference to the mechanism for establishing its value) and 8 (providing that the President of the Republic "may decide an external value" for the national currency, but remaining silent on the MMA's role in supporting that value).

23. Russian Central Banking Law, *supra* note 17, art. 3.

24. *Id.* art. 4(19).

25. *Id.* art. 8 (referring to Bank of Russia participation in the Savings Bank of the Russian Federation, the Bank for Foreign Trade, and five financial institutions operating outside Russia—with majority ownership in some of them).

26. Law of the Central Bank of Venezuela, art. 2, *at* http://www.law.nyu.edu/centralbankscenter/texts/Venezuela.html (last visited Oct. 12, 2004).

27. *Id.*

28. As explained in an IMF Operational Paper on central banking referred to in HEAD & RAMSEY, *supra* note 2, at 4: "A central bank should determine and implement monetary policy to achieve its target [of, for example, direct inflation levels]. To this end, the [central] bank should have authority to determine quantities and interest rates on its own transactions without interference from the government."

29. *See* Reserve Bank of New Zealand Act 1989, as amended through 2003, arts. 8, 9, 11, *at*

Another aspect of central bank independence also warrants attention even in so brief a summary as this, in part because it is this aspect that I have seen so often missing or ill-handled in central banking statutes. This aspect regards the governance of the central bank, and in particular the composition, appointment, and service of central bank governors and directors. In my view, a strong central bank statute would have provisions along these lines:

- *Composition of the board.* There would be no voting members on the board of directors drawn from government ministries, including the Ministry of Finance; but one government representative can, and often should, be included as a non-voting member.

- *Appointments.* Appointment of board members and central bank executives, such as the governor and deputy governors, would involve participation of two entities—for example, the head of state and the parliament.

- *Terms of office.* All board members and central bank executives would have fixed terms—longer in duration than the term of office of any entity involved in appointing them—and would be immune from removal except in the most serious circumstances. The government would have no authority to reduce the salaries of such officials during their terms of office.

- *Qualifications and status of governor.* The head of the central bank, typically called the governor, would be a person of high repute, with demonstrated expertise in central banking and institutional management skills, and at least a certain degree of political objectivity. He or she would, of course, devote full-time energies to the position.

- *Personnel matters.* Authority to handle all matters relating to hiring and firing of central bank officials, other than the governor and other top managers, would be granted in the central bank statute to the central bank's management.

Despite the seemingly obvious character of provisions such as these, political pressure to exercise control over a central bank is often quite strong (largely, of course, because of the financial resources that the central bank has under its

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http://www.legislation.govt.nz/browse_vw.asp?content-set=pal_statutes (last visited Feb. 8, 2005) (establishing that the Reserve Bank's "primary function" is "to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices" and that the Treasury Minister shall fix policy targets for implementation by the central bank in order to carry out that function). An authority on central banking has observed that whereas New Zealand chose price stability as the sole objective of monetary policy, other developed countries have taken a range of approaches to emphasizing price stability, often without making any formal change to the statutory mandate of the central bank. SIKLOS, *supra* note 11, at 14.

control), and many central bank laws lack some or all of these provisions regarding the institution's governance. In Bhutan, for example, the central bank's five-member board of directors falls largely under government control, with the Minister of Finance and the Secretary of Finance designated as the board's Chairman and Vice-Chairman, respectively.[30] Similarly, the Maldives central banking law provides for a board of directors and a central bank management dominated by government officials, especially finance ministry officials, all of whom are appointed either directly or indirectly by the President of the Republic, with no parliamentary involvement, and serve at the President's pleasure.[31] In contrast, the Russian central bank law provides for two entities—the parliament and the President of the Russian Federation—to be involved in the appointment of the central bank chairman,[32] and it calls for three entities—the parliament, the President of the Russian Federation, and the chairman of the central bank—to be involved in the appointment of board members.[33] Moreover, those board members cannot also be legislators or government officials or belong to political parties.[34] Provisions such as these help facilitate the kind of independence that central banks need in order to carry out their functions effectively.[35]

III. IMPOSING INTERNATIONAL BANKING STANDARDS [36]

In recent years, a comprehensive fabric of banking standards has developed internationally, thanks in part to the efforts of the Basle Committee on Banking Supervision, a committee of banking supervisory authorities established in the mid-1970s and consisting of representatives from several economically developed and powerful countries.[37] An enumeration of such internationally-accepted banking standards appeared in 1997 in the form of the Basle Committee's *Core Principles for Effective Banking Supervision*.[38] Many of these

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30. The Royal Monetary Authority of Bhutan Act, 1982, art. 13, *at* www.law.nyu.edu/centralbanks center/texts/bhutan.html (last visited Oct. 12, 2004).

31. *See* MMA Act, *supra* note 13, arts. 6 and 8.

32. Russian Central Banking Law, *supra* note 17, art. 14.

33. *Id.* art. 15.

34. *Id.* art. 19.

35. I have not tried in this summary to discuss all aspects of central bank independence. For some other points in this regard—including, for example, the need for a central bank to have a high degree of financial autonomy through budgetary and capitalization provisions. see Table I in RAMSEY & HEAD, *supra* note 2, at 4. For an explanation of the distinction between "instrument independence" and "goal independence," see Freedman, *supra* note 3, at 103.

36. I have offered a similar explanation of international banking standards in Head-1998, *supra* note 2, at 80-85.

37. Details about the Basle Committee (or, by its alternative spelling, the Basel Committee) and its activities are available on the website of the Bank for International Settlements, http://www.bis.org/bcbs/aboutbcbs.htm (last visited Oct. 12, 2004). For an excellent survey of the work of the Basle Committee, and of international cooperation in banking supervision more generally, *see* Patricia A. McCoy, *Musings on the Seeming Inevitability of Global Convergence in Banking Law*, 7 CONN. INS. L.J. 433 (2000).

38. BASLE COMMITTEE ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING

standards are familiar to central bankers—especially in those countries that have adopted far-reaching IMF-supported reform programs, such as Korea.[39]

Based on my experience in various LDCs, I consider six of the internationally-accepted standards of banking operation and supervision to be so important that they should be expressly reflected in the legislation, or regulations, governing a country's banking sector. Those six standards concern the following issues: (i) licensing of new banks or substantial transfer of a bank's ownership; (ii) capital adequacy requirements; (iii) insider lending and single-borrower lending; (iv) foreign currency exposure; (v) accounting and reporting requirements; and (vi) legal authority to carry out examinations and impose corrective measures. I shall offer a brief explanation of the standards in each of these areas, along with some illustrations drawn from my experience and research.

Licensing. First, the central bank or other supervisory authority[40] should be given broad and unequivocal authorization over the licensing of a new bank and the transfer of a bank's shares. This point appears in two of the *Core Principles for Effective Banking Supervision*:

> Principle 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.

SUPERVISION (September 1997), *available at* http://www.bis.org/publ/bcbs30a.pdf (last visited Oct. 7, 2004) [hereinafter CORE PRINCIPLES]. Many of the Core Principles resemble (though in more general form) provisions found in U.S. banking law. For a synopsis of some of those provisions, see LOVETT, *supra* note 5, at 122 (describing bank licensing rules and procedures), 128-33 (comparing U.S. and international capital adequacy requirements), 158-60 (describing insider lending restrictions), 141-44 (noting some key reporting requirements).

39. In the IMF-supported program to assist Korea during the Asian financial crisis, Korea pledged (among other things): (i) to set a timetable for all banks to meet or exceed Basle Committee standards on capital adequacy (a matter discussed more fully below); (ii) to strengthen accounting standards and rules to meet international practice and require large financial institutions to have their financial statements audited by internationally recognized firms; (iii) to require financial institutions to publish twice yearly key data on loans, capital, and ownership; and (iv) to pass legislation consolidating the supervision of all banks in an agency with operational and financial autonomy. INTERNATIONAL MONETARY FUND, REPUBLIC OF KOREA: IMF STAND-BY ARRANGEMENT (Dec. 5, 1997), *available at* http://www.imf.org/external/np/oth/korea.htm. For some observations on how international banking standards have been adopted in Brazil, both before and after the financial crisis that it faced in the late 1990s, see Jorge M. Guira, *Preventing and Containing International Financial Crisis: The Case of Brazil*, 7 L. & BUS. REV. AM. 481, 503-05 (2001).

40. As indicated above, I believe banking supervision authority is typically best placed with the central bank in LDCs. *Supra* note 8 and accompanying text. However, the same principles expressed here would apply regardless of which government entity is responsible for banking supervision.

> Principle 4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interest in existing banks to other parties.[41]

The justification for setting strict criteria for the entry of a new bank into the new system should be obvious: to protect the interests of the depositors and the integrity of the financial system as a whole. Entry restrictions should not be used, of course, to shelter poorly-run existing banks from the rigors of new competition. However, entry restrictions can provide important protection against a host of dangers, including incompetent or untrustworthy managers, inadequate capitalization, sloppy lending practices, faulty record-keeping, and the like. Strict control over the entry of new banks is preventive in nature, aimed at avoiding the need for later, probably expensive, cures. Bank licensing authority is therefore closely related to bank supervisory authority, and that is one reason I favor having both of these functions entrusted to a single institution—preferably a central bank having the type of independence referred to above in part II of this article.

Once the bank is established, the supervisory authority must have a related power: to review and, if necessary, disapprove another method of "entry" into the banking system: buying into an existing bank. That is the subject of Principle 4 quoted above. Even if a bank's original owners and managers are honest and competent, all that honesty and competence could disappear if a pack of scoundrels were to purchase a controlling interest in the bank. This fact is reflected in the Russian central bank law, which requires that "[t]he acquisition . . . of more than 5 per cent of shares . . . of a credit institution shall require that the Bank of Russia be notified, and more than 20 per cent the latter's prior consent."[42]

Capital adequacy. The second of the six areas of international banking standards that I consider crucial is that of capital adequacy. Capital adequacy refers to the ability of a bank to face risks by relying on amounts that have been paid in by the shareholders, together with certain other reserves. One of the Basle Committee's "Core Principles" focuses on this element:

> Principle 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. . . .[43]

41. CORE PRINCIPLES, *supra* note 38, at Principles 3, 4.
42. Russian Central Banking Law, *supra* note 17, art. 61.
43. CORE PRINCIPLES, *supra* note 38, at Principle 6.

The explanatory text accompanying the "Core Principles" elaborates on the importance of a bank's equity capital:

> [I]t provides a permanent source of revenue for the shareholders and funding for the bank; it is available to bear risk and absorb losses; it provides a base for further growth; and it gives the shareholders reason to ensure that the bank is managed in a safe and sound manner. Minimum capital adequacy ratios are necessary to reduce the risk of loss to depositors, creditors and other stakeholders of the bank and to help supervisors pursue the overall stability of the banking industry.[44]

Capital adequacy requirements typically revolve around ratios that prescribe how much capital is required in order to accommodate certain levels of risk posed by the bank's operations or assets. The details regarding the calculation of these capital adequacy ratios are unimportant for our present purpose,[45] so long as the central concept is clear: a bank's strength to roll with the punches of a competitive market can be gauged in part by dividing its capital (as defined in rather complex terms) by its "risk-weighted assets" (also as defined in rather complex terms). Accordingly, the central bank, or other banking supervisory authority, should prescribe and enforce those capital adequacy ratios.[46]

A relatively explicit statutory provision authorizing the central bank to prescribe and enforce capital adequacy ratios appears in the Banking Law of Cyprus. It not only states that "the Central Bank may . . . require banks . . . to maintain a capital adequacy ratio at such minimum level as may be determined by the Central Bank from time to time for each bank individually having regard to its circumstances,"[47] but also emphasizes that the central bank should be guided by "international practice" that bears on defining and prescribing such ratios.[48]

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44. *Id.* at 23.

45. Some of those details are explained in Head-1998, *supra* note 2, at 82-83. Full details, of course, are available from the Basle Committee, which in 1988 established a capital measurement system commonly referred to as the Basle Capital Accord. That system is now under review, in an initiative referred to as "Basle II." For information about the original Basle Capital Accord and about Basle II, see www.bis.org/bcbs/aboutbcbs.htm.

46. This would usually be done by regulation or directive issued by the central bank, and not in the banking laws themselves. A typical provision by which a central bank might do this could read as follows: "Each bank must maintain a minimum ratio of total capital to risk-weighted assets of at least 10%." Such a ratio would be changed by the central bank from time to time as circumstances might warrant; and different ratios could be prescribed for different categories of banks based on the relative strength of their operations or management.

47. Cyprus Banking Law, *supra* note 21, art. 21.(1).

48. *Id.* art. 41.(2). This provision, noting the importance of "the international practice," is referred to in the specific provisions on capital adequacy. *Id.* art. 21.(1).

Insider lending and single-borrower lending. The third of the six areas of international banking standards that should, in my view, be expressly dealt with in legislation relates to two types of risky loans that banks are often tempted to make—insider loans and single-borrower loans. A bank engages in insider lending (sometimes called "connected lending") when it provides loans to its own shareholders, managers, other employees, or their relatives. Doing so, especially on preferential terms, can lead to a situation in which insiders suck the bank dry of its resources. A bank engages in single-borrower lending (sometimes called "large-exposure" lending) when it lends a large amount of money to one entity, or several entities related to each other by share ownership. The risk in such a practice, of course, is that a bank might expose itself so much to a single borrower that a single default could ruin the bank.

How such practices might, as a legal matter, be regulated, can be illustrated by two sample provisions—the first on insider lending and the second on large-exposure lending. Both of these would rely in turn on exacting definitions of such terms as "bank insider," "related person," and "total capital:"

> The maximum amount of credit that a bank may provide to a bank insider, including credit to any person related to that bank insider, shall be equal to 5% of the bank's total capital, and the maximum amount of credit that a bank may provide in the aggregate to bank insiders and persons related to bank insiders shall be equal to 20% of the bank's total capital. The terms and conditions on which any such credit is provided shall be no more favorable than those generally applicable.
>
> The maximum amount of credit that a bank may provide to any one person or group of related persons shall be equal to 10% of the bank's total capital.[49]

In addition to imposing ceilings on such risky lending, some banking laws require special approval procedures for such lending. In Cyprus, for example, a bank may not make a loan to a director "unless the transaction was approved by a resolution of the Board of Directors carried by a majority of two-thirds of the total number of directors . . . and the director concerned was not present during the discussion of this subject by the Board."[50]

Foreign currency exposure. This is the fourth of the six areas of international banking standards that I consider most important in banking regulation,

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49. I have drawn these sample provisions from my own experience. Russian law has provisions similar to these sample provisions, although with very different percentages than I have suggested above. *See, e.g.*, Russian Central Banking Law, *supra* note 17, art. 71 (imposing a fifty percent ceiling on lending to shareholders) & art. 64 (imposing a twenty-five percent ceiling on single-borrowing lending). For the treatment given by the Basle Committee to insider lending and large-exposure lending, see CORE PRINCIPLES, *supra* note 38, at Principles 10 and 9, respectively.

50. Cyprus Banking Law, *supra* note 21, art. 11(1)(c).

especially in countries with relatively weak financial sectors. Foreign currency exposure played an important and pernicious role in the Asian financial crisis starting in 1997. In Thailand, for example, some local banks had borrowed in dollars, converted those borrowed dollars to local currency, and then made loans in local currency. When the local currency dropped in value, against the dollar, by about half over a six-month period, the banks faced deep problems. Even if their own borrowers repaid them in full, which of course became increasingly unlikely, the local currency that the banks were receiving from those loan repayments could not cover the dollar repayment obligations the banks had under the loans they had taken.

Restricting the ability of banks to enter into such arrangements—that is, to engage in foreign borrowing for purposes of funding domestic lending—could help prevent financial disaster. The importance of requiring banks to operate prudently in their operations involving other currencies and countries appears in general terms in one of the Basle Committee's *Core Principles*:

> Principle 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.[51]

Accounting and reporting. Another key element in the international standards regarding bank operation and regulation relates to information. Several of the forms of regulation referred to in the preceding paragraphs can be enforced only if the banks provide accurate and usable information on a regular basis. The *Core Principles* make this point as follows:

> Principle 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 the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.[52]

Related to this principle are several others stated in the *Core Principles* emphasizing the importance of ensuring that banking supervisors have full access to information from and about the banks, as well as adequate means for validating such information.[53] Such matters should be thoroughly addressed in a

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51. CORE PRINCIPLES, *supra* note 38, at Principle 11.

52. CORE PRINCIPLES, *supra* note 38, at Principle 21. Of course, for the financial information being provided by banks to be credible it must be based on internationally-accepted accounting principles and should be subjected to the scrutiny of an external audit—points also made in the CORE PRINCIPLES. *See id.* at 36.

53. *Id.* at Principles 18 and 19.

country's banking laws. Cyprus offers a useful example in this regard. Its banking law includes detailed provisions requiring banks to submit to the Central Bank, within certain time periods, specified types of financial statements for each year and for each month, with the yearly statements to be certified by an approved auditor.[54]

Enforcement powers. The last of the six areas of banking operation and supervision that I consider most important concerns enforcement of the standards prescribed by statute or regulation. The central bank, or other institution responsible for banking supervision, should be empowered by statute to issue implementing regulations, to undertake both off-site surveillance and on-site examination of banks,[55] and to take a variety of enforcement actions with respect to banks that fail or refuse to comply with the applicable requirements. These actions should range from the issuance of a warning to the revocation of a bank's license. They should include the power to impose fines, to issue cease-and-desist orders, and to suspend or dismiss bank management in extreme cases.

Cyprus provides an illustration of such enforcement powers. The Cyprus Bank Law includes this set of provisions:

> The Central Bank may take all or any of the following measures where a bank fails to comply with any of the provisions of this Law, or of any Regulations made under this Law or with the conditions of its licence, or in the opinion of the Central Bank the liquidity and character of its assets have been impaired or there is a risk that the ability of the bank to meet promptly its obligations may be impaired, or where this is considered necessary for the safeguarding of the interests of depositors or creditors—
>
> (a) require the bank forthwith to take such action as the Central Bank may consider necessary to rectify the matter;
>
> (b) completely prohibit until further notice the acceptance of deposits or the granting of credit facilities by the bank, or both;
>
> (c) consult with other banks with a view to determining the action to be taken;

54. Cyprus Banking Law, *supra* note 21, arts. 24-25. In addition to these precise requirements, a catch-all provision goes on to authorize the Central Bank to require a bank to submit "such other information and within such time as may be specified by the Central Bank." *Id.* art. 25(2).

55. "Off-site surveillance is a method of prudential bank supervision that relies on periodic submission of data from banks . . . to the supervisory authority, usually through returns on a monthly or quarterly basis." RAMSEY & HEAD, *supra* note 2, at 13. Because off-site surveillance cannot reveal all that needs to be known about a bank, especially intangible matters relating to its management, off-cite surveillance must be complemented by on-site examination, which gives "a first hand view of bank operations" and often focuses on the overall financial condition of a bank by evaluating its capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risks—a set of components referred to as the CAMELS system (for the first letters of each of these factors). *Id.* For an explanation of the CAMELS system as applied in the United States, see LOVETT, *supra* note 5, at 143-44.

(d) assume control of, and carry on in the bank's name, the business of the bank, for so long as the Central Bank may consider necessary, whereupon the bank shall be obliged to provide the Central Bank with such facilities as the Central Bank may require for carrying on the business of the bank;

(e) revoke the licence of the bank.[56]

Provisions of this sort also appear in Russian law.[57] In addition, many countries' banking legislation prescribe fines and other criminal penalties that can be imposed on banks that fail or refuse to abide by the rules and procedures established by the supervisory authority.[58]

In some cases, the condition of a bank is so bad that more drastic measures are necessary. As discussed below in part IV, the central bank should also have authority to handle such a situation by placing the bank under receivership, in accordance with "exit policy" rules designed to remove a bad bank from the system in order to keep it from infecting other banks.

IV. "EXIT POLICY"—HANDLING FAILED BANKS

Part II of this article emphasized the importance of central bank independence, in order to protect such institutions from the types of short-term political influence that have proven disastrous in many countries. Part III highlighted certain key international standards that should be imposed on commercial banks in order to maintain a healthy financial system, one that is largely free of bank failures. However, it is almost impossible to completely eliminate the risk of bank failures. Unfortunately, incompetence and dishonesty can be hidden, or a major external economic shock can place unanticipated strain on a country's banks. In short, problem banks and insolvent banks can emerge even in a banking system that is generally sound. Indeed, this possibility is intrinsic to an economic system based on private-sector activity; where private sector persons (whether involved in banking or in some other business) are given an opportunity to succeed, they will sometimes fail.

However, bank failure is different from other types of business failures in that a single bank failure can infect public confidence in *all* banks, and in serious cases can cause public panic, runs on banks, and maybe even a total meltdown of a financial system. A relatively recent example of bank runs appeared in Indonesia when it was in the throes of the Asian financial crisis. According to Alan Greenspan, the bank runs in that country "reached crisis proportions"

56. Cyprus Banking Law, *supra* note 21, art. 30(1).

57. *See* Russian Central Banking Law, *supra* note 17, art. 74.

58. *See, e.g.*, Cyprus Banking Law, *supra* note 21, art. 43 (specifying fines for infringement of the banking law); Russian Central Banking Law, *supra* note 17, art. 75 (authorizing the central bank to impose fines of up to one percent of a bank's minimum authorized capital).

during late 1997 because "[t]he state of confidence so necessary to the functioning of any economic ha[d] been torn asunder."[59]

The risks of such bank runs, and the systemic failure that could emerge from them, have prompted many countries to look to a special set of rules for handling insolvent banks. Such rules create and govern what is often called "exit policy" because they set forth the grounds and procedures on which a financial institution can be ushered out of the financial system without endangering the financial system as a whole.

I have written fairly extensively elsewhere about "exit policy" rules and procedures,[60] and my aim here is not to repeat or summarize what I have written earlier. Instead, in keeping with my theme in this article, I merely offer some observations about "getting down to basics"—that is, about the fundamental points that I think national authorities in LDCs should pay attention to, especially in their banking legislation, to prevent individual bank failures from creating financial crises.

The first such fundamental point is a matter of definitions. National banking legislation should clearly address this question: "What is bank insolvency?" In my view, the answer to the question should have two parts, to reflect two key forms of insolvency as generally accepted in international practice: (i) liquidity-based insolvency and (ii) "book insolvency." The first of these focuses on the ability of the bank to meet its obligations as they come due in the ordinary course of business. If, for example, a bank is not able to timely meet the demands of depositors wishing to withdraw their deposits, or of other creditors, because the bank has insufficient cash or readily marketable securities, then this bank would meet the liquidity-based test for insolvency. By contrast, "book insolvency" focuses on the balance, or imbalance, between the bank's assets, liabilities, and capital. A bank is "book insolvent" if its identified "losses" have extinguished, or will soon extinguish, its "regulatory capital." For these purposes, "losses" are defined as assets or loans that are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. "Regulatory capital," sometimes referred to as "capital and reserves," is defined according to certain standards established by the Basle Committee, referred to earlier in this article. An alternative formulation of the "book insolvency" test is that the value of the bank's liabilities exceed the value of its assets.

The tests mentioned above for determining the insolvency of a bank will probably differ from those used in a country's general bankruptcy laws, and this fact brings me to my second fundamental point about "exit policy" issues: banks warrant separate treatment from all other businesses. In several countries, I have seen tension between two competing approaches: (1) handling bank insolvencies under the bankruptcy rules and procedures that apply to other businesses in the

59. Greenspan, *supra* note 4.

60. *See generally* RAMSEY & HEAD, *supra* note 2.

economy, versus (2) handling bank insolvencies under separate rules and procedures. I strongly urge the latter, for several reasons. Among those reasons are: (i) that banks are different from other companies in terms of the contagion that one bank's failure can create; (ii) that banks are different from other companies in terms of the financial relationship that they have with depositors; and (iii) that banks are dramatically different from most other companies (or at least should be) in terms of the nature and complexity of government regulation over their operations. Accordingly, even in countries with well-developed general bankruptcy laws and procedures, it makes most sense to have separate rules and procedures to deal with financially troubled banks. And where, as in many LDCs, the general bankruptcy laws and procedures work poorly or slowly, handling bank insolvencies separately is, in my view, absolutely essential.

A third fundamental point about "exit policy" issues concerns aims and destinations. If a bank is found to be insolvent, what should be done about it? What should be the underlying aim of the "exit policy," and what possible alternative destinations are there for such a bank? In my view, the underlying aim should be to protect the interests of depositors and other creditors of the bank itself and of other banks whose financial position might be damaged if a crisis of confidence arises. The aim is *not* to protect owners and managers of the bank; after all, they are typically the ones who are largely responsible for the failure of the bank.

To achieve this general aim of protecting depositors, other creditors, and the banking system as a whole, a banking law might describe several specific avenues of action for handling an insolvent bank—what I refer to as "alternative destinations" for that bank. These could include such things as conservatorship, recapitalization, liquidation, bridge bank arrangements, and others.[61] Without attempting a detailed review of these, I will simply offer my view that the best way to handle an insolvent bank is to place it in receivership for purposes of undertaking either (i) a purchase-and-assumption transaction or (ii) a liquidation and distribution of proceeds.

In brief, a purchase-and-assumption transaction is a transaction in which a healthy institution purchases some or all of the assets of a failed bank and assumes some or all of its liabilities. Purchase-and-assumption transactions can take many forms, distinguished mainly by the extent to which the insolvent bank's assets pass to the acquiring institution.[62] A key purpose of any such transaction is to keep alive as many of those portions of the failed bank as possible, including most importantly the deposits of depositors. Because of this key purpose, a purchase-and-assumption transaction is typically less disruptive to a community and a financial system than would be a liquidation and distribution

61. *See* RAMSEY & HEAD, *supra* note 2, at 31-38 (describing these and various other methods of dealing with insolvent banks).

62. *See* RAMSEY & HEAD, *supra* note 2, at 76-77 (summarizing several types of purchase-and-assumption transactions).

of assets, and therefore is usually to be preferred where possible. But sometimes liquidation is impossible to avoid. In order to provide for such a destination for insolvent banks, a country's banking laws should set forth details on several points regarding liquidation and distribution, especially procedural points. For example, procedural safeguards are necessary to guard against overlooking the claims of any interested parties, and to ensure that a sale of the marketable assets of the insolvent bank is conducted in a transparent and timely manner so as to maximize the proceeds from such sale. Also critical in a liquidation-and-distribution process is the prioritization of interests. In particular, it is essential that the liquidated bank's depositors receive higher priority than the bank's shareholders in receiving proceeds of the distribution. As a practical matter, the shareholders typically would receive nothing.

A fourth fundamental point about "exit policy" issues concerns the character of a receivership, which is the vehicle by which either of these two destinations—a purchase-and-assumption transaction or a liquidation-and-distribution transaction—is to be reached. What is a receivership and how should it work? In my view, national banking laws should explicitly prescribe the qualifications, powers, and accountability of a person, or corporate legal entity, appointed as a receiver for an insolvent bank. The qualifications for an individual appointed to such a position, including, as would often be the case, a staff member of the central bank, should include extensive professional experience, unquestioned personal integrity, a clean criminal record, and no personal relationship by blood or marriage with the managers or shareholders of the bank being placed in receivership. In the case of a corporate legal entity being appointed to serve as a receiver, the legal entity must have as a principal officer handling the receivership a person who meets all the criteria mentioned above, and it must have adequate financial resources to provide necessary compensation of and guarantees against loss.

The powers of a receiver should be extensive enough for it to take firm control of the bank's management and assets in order to arrest its decline and protect its depositors and other creditors. Accordingly, the receiver should be empowered to continue or discontinue any operations, to borrow money, to fire old officers and hire new ones, to initiate or defend against legal actions, to amend the bank's charter, and to arrange for an infusion of additional capital. The exercise of some of these powers would be subject to approval by the central bank, assuming it is responsible for bank supervision.[63] The receiver would be ultimately accountable to the central bank. This accountability would be reflected in reporting requirements and in provisions imposing liability on the part of the receiver for any damage caused by the receiver's wrongful conduct.[64]

63. *See supra* note 8 (referencing the competing views about placing banking supervision powers with the central bank).

64. *See* RAMSEY & HEAD, *supra* note 2, at 70-72 (further detailing the qualifications, powers, and accountability of receivers).

Another issue relating to the "exit policy" a country establishes for handling troubled banks is how to address a situation where the central bank, or other supervisory authority, determines that a bank is *not* insolvent, or on the verge of insolvency, but merely suffers from one or more serious problems. In that case, the central bank should be empowered by explicit statutory provisions to impose on that troubled bank any one or more of a range of remedial measures. I alluded to some such measures in discussing enforcement powers in part III of this article. They include the issuance of cease-and-desist orders to prohibit the bank from continuing certain imprudent operations, and the suspension or dismissal of bank management. In addition, the troubled but not insolvent bank might be required to submit to the central bank a satisfactory program of action. For example, such a program may propose increasing reserves, reorganizing management, improving reporting procedures, or injecting new capital into the bank, in order to correct the bank's deficiencies. In extreme cases, the central bank might appoint a conservator to shepherd the bank back to safety and health.

If, however, it is too late for such measures because the bank has already been determined to be insolvent, or on the verge of insolvency, then the response by the regulators should be swift and sure in order to serve the protective aims noted above. Further, the statutory provisions for placing an insolvent bank in receivership should be mandatory, not subject to the discretion of the central bank. In other words, in order to protect the central bank against influence from powerful interests, including the insolvent bank's owners and their friends, the central bank should be required to move the bank into receivership immediately on a finding of insolvency.[65]

V. CONCLUDING OBSERVATIONS

I did not promise any dramatic new insights into international financial services, and I have not delivered any. Instead, I have merely urged that despite the increasingly sophisticated and complicated global financial environment, we recognize the importance of "getting down to basics," especially in our efforts to build a world of stable national financial systems. Drawing on my own experience in several countries with relatively undeveloped financial systems, I have highlighted what I regard as fundamental principles and practices in three areas: central bank independence, modern international banking standards, and rules and procedures for handling troubled or insolvent banks.

65. *See* RAMSEY & HEAD, *supra* note 2, at 34-35 (further discussing this point, including a reference to an exception if the central bank's capacity to handle receiverships is temporarily inadequate).

Specifically, I have urged that the authorities responsible for preparing or updating banking and central banking legislation in LDCs pay special attention to certain key points. First, as part of an overall effort to establish and nurture the independence of the central bank, such legislation should, among other things:

- impose strict limitations on central bank lending to the government;
- provide adequately broad authority to the central bank to inspect banks, impose requirements on them, and take remedial action for breach of those requirements (if the central bank has responsibility for bank supervision);
- specify price stability as the central bank's principal purpose, and give the central bank adequately broad powers to work toward accomplishing that purpose; and
- facilitate strong governance of the central bank through provisions on board composition, appointments, terms of office, and qualifications.

Second, national legislation on banking and central banking should reflect internationally-accepted standards of bank operation and supervision, including detailed and demanding provisions on:

- licensing of banks and the acquisition of controlling interest in banks;
- capital adequacy;
- insider lending and single-borrower lending;
- foreign exchange exposure;
- accounting and reporting; and
- inspections and enforcement.

Third, national banking legislation should incorporate clear rules and procedures regarding the removal of problem banks from the financial system—what I have referred to as an "exit policy." The following points should figure prominently in such an "exit policy:"

- the definition(s) of bank insolvency;
- the separation of rules on bank insolvency from the country's general bankruptcy rules;
- a focus on two main "destinations" for insolvent banks—purchase-and-assumption transactions and liquidation-and-distribution processes;

- the character of a receivership, and especially the qualifications, powers, and accountability of receivers; and
- the mandatory nature of receivership procedures once a bank is found to be insolvent.

In concluding, I would like to return to an observation I made in passing at the beginning of this article, having to do with the ultimate aim and importance of financial services, or at least of their regulation by national and international authorities. My own view, tempered and surely biased by over two decades of work in the area of economic development, is that the most important "clients" of our work and discussions regarding financial services—whether we are academics or civil servants or practitioners—are the people who are most directly affected by what I call the "corner banks." These are banks that conduct business on a small scale, often under local ownership and operating under the auspices of national and local government officials. The contagious financial crises that we saw in the twentieth century, most dramatically perhaps in the 1990s in Asia and Latin America and the former Soviet republics, fell most heavily on those people, simply because they constitute the largest population and the most vulnerable population. As the tendency for such contagion increases with the continued sophistication and globalization of financial services, the risk to those people grows commensurately. In my view, we must work to manage that risk and protect those people, not just as a means of facilitating a stable global financial system but also as a matter of ethics.