Yale University
EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Documents (Series 1) Browse by Media Type

4-3-1997

Current Legal Issues Affecting Central Banks, Volume IV.

Robert C. Effros

Follow this and additional works at: https://elischolar.library.yale.edu/ypfs-documents

Recommended Citation
Effros, Robert C., "Current Legal Issues Affecting Central Banks, Volume IV." (1997). *YPFS Documents (Series 1)*. 10773.
https://elischolar.library.yale.edu/ypfs-documents/10773

This Document is brought to you for free and open access by the Browse by Media Type at EliScholar – A Digital Platform for Scholarly Publishing at Yale. It has been accepted for inclusion in YPFS Documents (Series 1) by an authorized administrator of EliScholar – A Digital Platform for Scholarly Publishing at Yale. For more information, please contact elischolar@yale.edu.

Current Legal Issues Affecting Central Banks

Volume 4

Edited by Robert C. Effros

International Monetary Fund

Current Legal Issues Affecting Central Banks

Current Legal Issues Affecting Central Banks

Volume 4

Edited by Robert C. Effros

International Monetary Fund
March 1997

© 1997 International Monetary Fund

Design and production: IMF Graphics Section

Cataloging-in Publication Data

Current legal issues affecting central banks / edited by Robert C. Effros
p. cm.
Papers from seminars sponsored by the Legal Department of the IMF and IMF Institute.
Includes bibliographical references.

1. Banks and banking. Central—Law and legislation—Congresses.
2. Banking Law—Congresses. I. Effros, Robert C.
II. International Monetary Fund. Legal Dept. III. IMF Institute.
K1070.A55 1992 346'.08211—dc20
ISBN 1-55775-142-0 (v. 1 1988)
ISBN 1-55775-306-7 (v. 2 1990)
ISBN 1-55775-498-5 (v. 3 1992)
ISBN 1-55775-503-5 (v. 4 1994) 92-16996
CIP

Price: $65.00

Address orders to:
External Relations Department, Publication Services
International Monetary Fund, Washington D.C. 20431
Telephone: (202) 623-7430; Telefax: (202) 623-7201
Internet: publications@imf.org

Contents

Page

Introduction xi

DEVELOPMENTS AT INTERNATIONAL FINANCIAL INSTITUTIONS

1 Developments at the International Monetary Fund

1A. Some Specific Legal Features of the International Monetary Fund
François P. Gianviti 1

1B. The Relationship Between the International Monetary Fund and the United Nations
William E. Holder 16

1C. Issues Regarding the Special Drawing Right of the International Monetary Fund
Reinhard H. Munzberg 26

2 Developments at the International Bank for Reconstruction and Development: The Restructuring of the Global Environment Facility
Andrés Rigo 29

3 Developments at the International Finance Corporation
Jennifer A. Sullivan 35

Comment (on Chapters 2 and 3)
William M. Berenson 40

4 The First Three Years of the European Bank for Reconstruction and Development: Legal Issues and Solutions
Andre Newburg 45

Comment
Russell L. Munk 61

REGIONAL DEVELOPMENTS AFFECTING CENTRAL BANKS

5 European Monetary Union and the European System of Central Banks
Cynthia C. Lichtenstein 65

Comment
Rosa Maria Lastra 73

6 **The European Community's Second Banking Directive**
René Smits 83

7 **Banking Law Developments in the European Union: Deposit Insurance and Money-Laundering Initiatives**
Paolo Clarotti 105
Comment (on Chapters 6 and 7)
Sydney J. Key 124

8 **GATT and Its Effect on Banking Services**
Kathleen M. O'Day 131
Comment
Marilyn L. Muench 138

9 **The Implications of NAFTA for Central Banks**
Keith A. Palzer 143
Comment
Boris Kozolchyk 156

10 **Banking Law Developments in Latin America**
Jorge Guardia 159
Comment
Ernesto V. Feldman 169

COUNTRY-SPECIFIC DEVELOPMENTS AFFECTING CENTRAL BANKS

11 **U.S. Banking Regulation Roundtable**
11A. Report from the Board of Governors of the Federal Reserve System: Establishing Foreign Bank Offices in the United States
J. Virgil Mattingly, Jr. 173
11B. Report from the Federal Deposit Insurance Corporation: National Deposit Insurance Has Worked to Promote Banking Stability
Thomas A. Rose, Christine M. Bradley, and Linda L. Stamp 181
11C. Report from the Office of the Comptroller of the Currency: The Future of Bank Supervision
Raija Bettauer 187

11D. Report from the Office of Thrift Supervision
Carolyn J. Buck 190
Comment
John S. Baerst 198

12 Banking Reform in the United States
Fé Morales Marks 203
Comment
Michael Bradfield 226

13 Banking Law Developments in the United Kingdom
William Blair 235

14 Banking Law Developments in Canada
Guy David 257
Comment (on Chapters 13 and 14)
Melanie L. Fein 271

15 Banking Law Developments in the Former Soviet Union
Tony Shea 275
Comment
Deborah K. Burand 283

16 Banking Law Reform in China
Tobias M.C. Asser 289
Comment
Natalie G. Lichtenstein 299

TOPICS OF SPECIAL INTEREST AFFECTING CENTRAL BANKS

17 Banking Supervision Around the World
17A. The Role of the Central Bank
Larry Promisel 307
17B. Bank Supervision in the G-7 Countries
Elizabeth Roberts 314
Comment
John P. Danforth 322

18 Who Should Be the Banking Supervisors?
18A. Some General Considerations
Ian H. Giddy 325
18B. A German Perspective
Bertold Wahlig 336
18C. A Swedish Perspective
Robert Sparve 345

18D. French Banking Supervision
Jacques Milleret 356
Comment
William E. Alexander 367

19 BCCI: The Lessons for Banking Supervision
Thomas C. Baxter, Jr. and Jet Joseph de Saram 371
Comment
Larry Gurwin 388

20 The Role of Deposit Insurance: Financial System Stability and Moral Hazard
James R. Barth and R. Dan Brumbaugh, Jr. 393
Comment
V. Gerard Comizio 411

21 Bankruptcy: Policy, Law, and Strategy
21A. Bankruptcy Policies, Restructuring, and Economic Efficiency
Izak Atiyas 421
21B. An Explanation of, and Guide to, Business Reorganizations Under Chapter 11 of the U.S. Bankruptcy Code
Roger M. Whelan 430
21C. Bankruptcy Law and Bank Insolvency Law in Eastern Europe
Henry N. Schiffman 437

22 The New Foreign Exchange Master Agreements
22A. The Significance of the International Foreign Exchange Master Agreement
John P. Emert 441
22B. An Analysis of the International Foreign Exchange Master Agreement
Ruth Ainslie 450
Comment
Raj Bhala 458

23 Financial Derivatives
23A. Over-the-Counter Derivatives
Daniel P. Cunningham 465
23B. The Risks of Financial Derivatives
Kenneth Raisler 474
Comment
David Folkerts-Landau 482

24 Securitization: Has It Matured?
Mark J. Welshimer 487
Comment
Sandra M. Rocks 510

25 Payment Systems . . . .
25A. Legal Issues Regarding Payment and Netting Systems
Mario Giovanoli 517
25B. Risks in the Large-Value Payment System and the Role of Netting
H. Rodgin Cohen 541
Comment
Andrew T. Hook 551

26 Securities Transfers
26A. Delivery Against Payment
Ernest Patrikis 555
26B. Legal Issues Regarding Payment and Settlement
MarySue Fisher 562
26C. Securities Clearance and Settlement
Simon M. Lorne 567
Comment
Charles W. Mooney, Jr. 574

27 International Banking Capital Standards for Market Risk: Recent Developments and Possible New Directions
James V. Houpt 577
Comment
Raija Bettauer 591

Appendices

I International Agreements

1. General Agreement on Trade in Services 597
   1a. Understanding on Commitments in Financial Services 627
2. North America Free Trade Agreement [Selected Provisions] 632

II International Financial Materials

Master Agreements
1. International Foreign Exchange Master Agreement (IFEMA) 683

2. International Currency Options Market (ICOM) Master Agreement 701
3. International Swap Dealers Association (ISDA) Master Agreement 718

Derivatives

4. Group of Thirty Recommendations on Derivatives . . 742
5. Joint Report on the Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms [Excerpt] 760
6. Basle Committee Report on Banking Supervision Risk Management Guidelines for Derivatives [Excerpt] 772
7. OCC Banking Circular No. 277: Risk Management of Financial Derivatives [Excerpt] 780
8. Principles and Practices for Wholesale Financial Market Transactions 786

Netting

9. Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries [Excerpt] 797
10. Report on Netting Schemes Prepared by the Group of Experts on Payment Systems of the Central Banks of the Group of Ten Countries [Excerpt] . . 798

Other

11. Basle Committee Amendment of the 1988 Capital Accord 799
12. Basle Committee Report on Asset Transfers and Securitisation 806
13. The London Code of Conduct for Principals and Broking Firms in the Wholesale Markets 817

III European Community Documents

1. EC Directive on Deposit-Guarantee Schemes 861
2. EC Directive on Unfair Terms in Consumer Contracts 879

Notes 889

Biographical Sketches 963

Introduction

> He that will not apply new remedies must expect new evils; for time is the greatest innovator.
>
> *Francis Bacon*

In recent years, traditional central banks, with decades or even centuries of experience behind them, have been confronted with entirely new worlds. Some of these worlds are the results of innovations that have grown out of the new technology of the computer. Examples of such innovations that are discussed in this volume include derivatives and products of securitization. Derivatives, lacking intrinsic value of their own, derive value from some external source, for example, a moving index of securities. Securitizations, in hypermodern forms, can give rise to such exotics as stripping interest payments over the life of a security from principal payments and issuing two or more series of securities, perhaps with different maturities, the value of which together may represent the original security from which they were drawn. Other worlds are the results of intraregional consolidation, such as recent developments in the European Community and the creation of the North American Free Trade Agreement (NAFTA).

While certain chapters in this volume focus on some of these new worlds of finance, others hark back to some of the traditional considerations associated with central banks. Can the traditional central bank deal with the explosion of worlds before it? In this introduction, attention is first directed to some basic aspects of the central bank.

The classic literature concerning a central bank deals primarily with its functions, responsibilities, powers, instruments, and effects. Little has been written concerning its intrinsic nature, its position in the general social fabric, and, in particular, its place in the legal framework.

In what follows, the central bank will be viewed as an administrative agency. Its powers will be compared to those of the several branches of government. Finally, its autonomy and ultimately its accountability to these branches and the public will be reviewed. While the institutions examined remain distinct, in the main features of their jurisprudence a convergent evolution seems to be emerging.

The Central Bank: An Administrative Agency

From the aspect of legal analysis, a central bank is an administrative agency. Moreover, it is often a relatively independent administrative agen-

cy that is set up in corporate form with collegial decision making occurring through the deliberations of a board of directors. It may be distinguished from a pyramidal government department or an administrative agency with a single administrator responsible for all regulatory policy (even though some rudimentary or anachronistic central banks may take this form). This is because the complex nature of a central bank's policymaking is believed to benefit by discussion, interaction, and compromise among several persons with different points of view.

If a central bank is an administrative agency, how does it fit within the legal framework of a country?

The Three Branches of Government

In traditional legal analysis, government may be divided into three branches. The French philosopher Montesquieu discerned in government (i) a legislative power, (ii) an executive power, and (iii) a judicial power. He counseled that the three powers should be kept separate from one another in the interest of avoiding tyranny and promoting good government.[1] This analysis was incorporated into a number of constituent frameworks, including the Constitution of the United States (where Article I is devoted to the legislature, Article II to the executive authority, and Article III to the judiciary). Initially, some observers argued for a hermetic separation of the three branches of government. If this had been generally accepted, a central bank, like every other administrative agency, would have to be considered a mere appendage of one of the three branches of the government. However, James Madison put forward a broader vision in the *Federalist Papers* that sought to explain the idea upon which the U.S. Constitution had been based. Madison believed that from the counsels

> by which Montesquieu was guided, it may clearly be inferred that in saying "There can be no liberty where the legislative and executive powers are united in the same person, or body of magistrates," or, "if the power of judging be not separated from the legislative and executive powers," he did not mean that these departments ought to have no partial agency in, or no control over, the acts of each other.[2]

In Madison's view, cases could arise in which a blend of powers among the three branches could be appropriate (since danger arose in his opinion only "where the whole power of one department is exercised by the same hands which possess the whole power of another department").[3] As the doctrine of separation of powers evolved in the United States, Madison's view gained ascendancy, and it was eventually accepted that it was "left to each [authority] power to exercise, in some respects, functions in their nature executive, legislative and judicial."[4]

Administrative Agencies: A Fourth Branch?

If some combination or blend of powers among the three branches of government could be contemplated, was this blend permitted only to each of the three recognized branches of government, or could such a combination be institutionalized in an independent agency outside the parameters of these branches? In the case of a central bank (or, more generally, an administrative agency), would the institution to be created once again be within the bounds of one of the three powers of government (even though possessed of a blend of powers from all three branches) or could it be truly outside them all—a sort of fourth branch or power of government? Whatever the conclusion, the result would require delegation of authority from at least one of the branches that had been entrusted with it at the outset. In the ordinary case, this branch would be expected to be the legislature, which, by enacting a statute or granting a charter, would initially establish the new institution. The English philosopher John Locke argued with force, however, that legislative authority could not validly be delegated. The basis of his argument rests on the familiar legal ground that power entrusted to an agent because of the latter's special fitness for the task to be performed cannot be transferred by that agent if it would contradict the purposes of the initial transfer:

> The Legislative cannot transfer the Power of Making Laws to any other hands. For it being but a delegated Power from the People, they, who have it, cannot pass it over to others. . . . And when the people have said, We will submit to rules, and be govern'd by Laws made by such Men, and in such Forms, no Body else can say other Men shall make Laws for them; nor can the people be bound by any Laws but such as are Enacted by those, whom they have Chosen, and Authorised to make Laws for them. The power of the Legislative being derived from the People by a positive voluntary Grant and Institution, can be no other, than what the positive Grant conveyed, which being only to make Laws, and not to make Legislators, the Legislative can have no power to transfer their Authority of making laws, and place it in other hands.[5]

Nevertheless, despite the deceptive simplicity of this argument, it soon became obvious that the complexities of modern society and its economy cannot occupy every moment of the legislature (or for that matter, of the executive or judiciary, concerning which the same logic can be applied):

> In the modern State the bulk of legislation is so great that Parliament has not sufficient resources of time or personnel to concern itself with all matters of detail.[6]

In most countries, sooner or later, it is recognized that delegation of authority to specialized administrative agencies is necessary.

The advantages of administrative agencies are by now well-known. Administrative agencies can be created to concentrate technical knowledge and acquire specialized experience in the field to be regulated. They can, moreover, be staffed by objective and nonpolitical experts rather than by politicians. In addition, various kinds of administrative agencies can be created to deal with particular tasks and to perform special roles within society. Different blends of the three powers can then be made according to the task or role to be addressed. Thus, in theory, an administrative agency can be created (i) with executive powers only, (ii) with a mix of executive and judicial powers or executive and legislative powers, or even (iii) with executive, legislative, and judicial powers.[7] In practice, in accordance with their constituent charters or statutes, central banks may comprise a blend of elements of (ii) or even (iii).

A Central Bank's Authority

In the context of an administrative agency, generally, and of a central bank, in particular, executive authority may include powers to interpret and enforce legislation, make inspections, and prosecute violations. In this context, legislative authority may include powers to prescribe rules that have the force of law and to establish licensing criteria. Finally, the judicial authority may extend to conducting hearings, following specialized adjudicative procedures, construing legislation, finding facts, making conclusions of law, arriving at binding determinations concerning one or more parties, and imposing sanctions.[8] (However, these functions are only characteristic of, or associated with, the particular authority, and, in any event, they are not necessarily mutually exclusive among the authorities. Thus, a legislature may conduct hearings as well as the judiciary, and the executive authority may, like the judiciary, need to interpret statutes in individual cases. However, the essence of the work of the legislature is not likely to be the conduct of hearings and the essence of the work of the executive is not likely to be its expertise of interpretation.)

All these powers are useful to a central bank, and some of them are indispensable to its functioning. By way of example, the Federal Reserve is empowered to make inspections of member banks[9] and bank holding companies and their subsidiaries[10] and thus can exercise executive authority. It may prescribe regulations[11] that have the force of law on subjects within its jurisdiction and in this way exercise legislative authority. Finally, the Federal Reserve may hold hearings consonant with prescribed, specialized adjudicative procedures,[12] make binding determinations of facts and law concerning banks and bank holding companies, issue cease and desist orders,[13] remove officers[14] and assess civil money penalties[15] against banks and other parties, and accordingly exercise judicial author-

ity. However, since the range of responsibilities of central banks may vary from country to country, some central banks may require a fuller or lesser array of powers than others. Thus, some central banks (such as the Federal Reserve) are charged with responsibility for bank supervision, while other central banks may be exempt from this responsibility (the legislators having charged another agency with such authority). In Canada, for example, the Office of the Superintendent of Financial Institutions, which is part of the Department of Finance (reporting to the Minister of Finance), is the bank supervisory authority. In France, while the Bank of France exercises indirect authority over bank supervision, the Banking Commission, the Banking Regulations Committee, and the Credit Institutions Committee all play roles in this area. In Japan, bank supervision is the legal responsibility of the Ministry of Finance, although the Bank of Japan is also involved de facto. In Germany, the primary bank supervisory authority is the Federal Banking Supervisory Office, but it exercises its authority in close coordination with the Deutsche Bundesbank.

To the extent that the responsibility of a central bank is increased, the scope of its powers may need to be augmented. However, to the extent that the responsibility of the central bank is circumscribed, the amplitude of its powers may be reduced. It follows that, if a central bank is not expected to make regulations binding on the banking community but must defer to the Ministry of Finance in this regard, the central bank may not need legislative authority. Similarly, a central bank can dispense with some degree of executive authority if, under its enabling act, it lacks authority to prosecute violations of the law and is expected in such cases only to recommend prosecution to the attorney general.

To sum up, a central bank may be characterized as an administrative agency separate from the traditional three branches of government but possessing a blend of powers from each branch that is appropriate to the tasks appointed for it by the enabling legislation that creates the bank.

Central Bank Accountability

In recent years, a consensus has appeared in favor of central bank independence. The justification for this independence is the belief that, insulated from short-term political pressures, a central bank will be in a position to pursue long-term economic goals more effectively. Independence, however, is not the same as being unaccountable for one's actions. Thus, an administrative agency may take decisions on its own, but it may have to forecast, explain, and justify its decisions. An administrative agency, then, while prizing its autonomy of decision and action, may nevertheless be

accountable to one or more of the three branches of the government—and to the public at large. If it is accountable to no one, the situation may give rise to the risks against which Montesquieu warned when the powers of government are combined. Depending on the importance of the administrative agency, these risks may range from subversion of good government to tyranny within the arena in which the agency exercises its jurisdiction.

One may fairly ask, Why, if a combination of powers creates such risks, should a central bank (or, indeed, any administrative agency) be allowed to exercise them? The answer must lie in the increasing complexity of modern society, which requires the construction of such engines of integrated power to resolve satisfactorily the matters before them. The alternative would seem to be an increasing accumulation of unresolved problems, the primary responsibility for which is denied haphazardly by various government offices. This seems to be the fate of those societies that would enter the modern world without the bureaucratic machinery adequate to its challenges. Max Weber, the eminent German sociologist, wrote that one prerequisite of the modern capitalist-industrial state is a professional bureaucracy. The development of that bureaucracy has thus given rise to the modern administrative state. As a measure of this necessity consider, by way of example, one recent index of administrative growth in the United States:

> Here the not-entirely-symbolic measure is the Code of Federal Regulations (CFR). In its first year of publication, significantly 1939, the CFR consisted of sixteen volumes; last year it had expanded to 200 volumes, exceeding 60,000 pages combined. As these numbers suggest, delegation may have come about because the world became too complicated for Congress to handle alone, but it also enabled Congress to address more than it ever otherwise would have on its own.[16]

It is submitted, therefore, that providing for adequate accountability of administrative agencies, whose inevitability must be acknowledged, is of utmost importance.

In the case of a central bank, which is an administrative agency of unprecedented power, increasingly enjoying unparalleled independence, accountability may be conceived in terms of accountability of the bank to any or all of the three branches of the government, as well as to the public. While the situation may differ from country to country in accordance with the legal traditions and evolution of each, it is of interest to focus on the possible methods of accountability, all of which have their analogues in the world today. It should be noted that, in order to preserve a proper balance between autonomy and accountability, the elements of both may be qualified and conditional. Consider the ways in which a central bank may be made accountable for its actions. That it should be account-

able at all follows from the realization that its nature and structure tend to insulate it from effective external control. The trick is to make it accountable to, but not to the extent that it is controlled by, one or more external powers.

Central Bank Accountability to the Legislative Branch

A central bank may be made accountable to the legislative branch. One way of providing for parliamentary accountability is to require regular examination of a central bank's performance by a select or standing committee of the legislature. In Sweden, this takes the form of having the central bank report to a standing committee of the legislature.[17] In the United States, the Federal Reserve must report twice yearly to the banking committees of both the Senate and the House of Representatives on its monetary targets and its objectives and plans for the coming year.[18] Not only are reports mandated, but it has also become a tradition for the Chairman of the Board of Governors to appear before the committees to testify. Thereafter, each committee submits to its respective chamber of the legislature a report containing its views and recommendations with respect to the Federal Reserve's intended policies. In the United Kingdom, the Governor of the Bank of England appears before the House of Commons Treasury and Civil Service Select Committee on a regular basis.[19] (However, the Bank, as an incorporated public body, is not directly answerable to the Parliament. Under U.K. constitutional doctrine, parliamentary responsibility lies with a minister.) In France, the Governor of the Bank of France annually addresses a report on the Bank's activities and on monetary policy to the President of the Republic and Parliament. The Governor may be asked to appear before the finance committees of the two chambers of Parliament. The accounts of the Bank and the report of the statutory auditors are forwarded to the finance committees of the National Assembly and the Senate.

The chief power of the legislature, the power of the purse, is deliberately blunted in the case of most central banks because they almost invariably are invested with an autonomous power to decide on their own budgets without leave from their legislatures. Moreover, the power to decide on their own budgets is not merely theoretical. It is buttressed by the fact that most central banks are highly profitable institutions (even though profit maximizing is not usually among their purposes and should not be regarded as a measure of their efficiency). Accordingly, unlike most other parts of the government, central banks do not have to depend on their parliaments for their finances (although they may have to account for them to the legislative or to the executive branches of their governments). In this respect, most central banks must submit to independent audits in accordance with the terms of their statutes.

Central Bank Accountability to the Executive Branch

A central bank may be accountable to the executive branch. It is the executive branch that appoints the governor of a central bank and its board of directors. (It may do this with the advice and counsel of the legislature in some countries.) It is also the executive that may remove these appointees. Thus, in the United States, the seven members of the Federal Reserve Board are appointed by the President with the advice of the Senate.[20] However, the power of the executive branch to dismiss the central bank officials that it has appointed cannot be unfettered. Even as the chief power of the legislature (over the purse) is blunted in the case of a central bank, so the power to relieve the governor and the board members of their offices is also commonly hedged about with qualification. These persons do not serve merely at the pleasure of the appointing authority as might be the case if they were officers of the executive branch. In order to assure them sufficient independence of action, the causes for their dismissal must be limited. By way of illustration, Article 10 of the French central bank act provides that governors of the Bank of France may be relieved from office only if they no longer fulfill the conditions required for the performance of their duties or if they have been guilty of serious misconduct.[21] In the United States, the members of the Board of Governors of the Federal Reserve System can be removed from office only for cause,[22] a concept that is subject to judicial interpretation.

In addition to the power to appoint and dismiss, in some countries the executive branch may also exercise influence over a central bank through an express power of direction. Thus, the Bank of England Act 1946, which nationalized the Bank of England, provides a general statutory power in the Treasury to issue to the Bank such directions "as, after consultation with the Governor . . . they think necessary in the public interest."[23] Similar powers of direction may be found in the Canadian and Australian laws.

Central Bank Accountability to the Judicial Branch

Sovereign Immunity

A central bank may be accountable to the judicial branch. The jurisprudence of many countries recognizes a general rule that the sovereign cannot be sued without its consent. The basic rationale for this rule is that an unfettered right to bring private claims against the state would hamper the effective functioning of the government. This general rule, however, may be subject to statutory exceptions that are

intended to waive immunity for certain purposes. Under English law, since the enactment of the Crown Proceedings Act 1947, the liability of the Crown and other public authorities is recognized in order to grant recovery to a citizen for damages in tort and other enumerated claims.[24] Under French law, the principle of administrative liability (*responsabilité*) is also accepted, pursuant to special rules of administrative law, and extends to all public authorities.[25] As stated by one authority in the area:

> This principle is expressed in the judgment of the Tribunal des Conflits in *Blanco* (TC 8 February 1873) as follows:
>
> > Considering that the liability which may fall upon the state for damage caused to individuals by the act of persons which it employs in the public service cannot be governed by the principles which are laid down in the Civil Code for relations between one individual and another: that this liability is neither general nor absolute: that it has its own special rules which vary according to the needs of the service and the necessity to reconcile the rights of the state with private rights.[26]

In other countries, the central bank, generally recognized as a governmental instrumentality, may be subject to suit under its constituent law or under one of the exceptions carved out of the doctrine of sovereign immunity by a general statute regulating suits against the government. However, the liability of the central bank and its officers may be circumscribed. Thus, Section 44H of Trinidad's Central Bank Act provides that the central bank, its directors, and officers are not subject to liability in respect of acts done or omitted in good faith and without negligence.[27] Moreover, the U.K. Banking Act 1987 contains a similar provision, which is discussed subsequently.[28]

In the United States, Congress enacted the Federal Tort Claims Act, which waives in large measure the tort immunity of the government (subject to significant exceptions). The waiver permits the government to be sued for damages

> caused by the negligent or wrongful act or omission of any employee of the Government, while acting within the scope of his office or employment, under circumstances where the United States, if a private person would be liable to the claimant in accordance with the law of the place where the act or omission occurred.[29]

However, overriding this provision are two exceptions that are particularly noteworthy. The first is "any claim for damages caused by . . . the regulation of the monetary system,"[30] the traditional province of a central bank. The other exception applies to claims based on "the exercise or performance or the failure to exercise or perform a discretionary func-

tion or duty on the part of a federal agency or an employee of the Government, whether or not the discretion involved be abused."[31] The latter exception has been held by the U.S. Supreme Court to bar claims against federal bank supervisory agencies for negligent supervision of savings and loan operations.[32] In this connection, as is addressed subsequently, the reach of the exception has been particularly effective in defining the duties of the bank supervisors in the context of bank failures.

In appropriate circumstances, banks and other persons who have suffered an invasion of their rights by a central bank or its officials must have the right to sue for relief. However, this right, especially as it involves judicial review of the decisions of a central bank, may need to be qualified. To understand how this judicial review may be qualified, it is instructive to consider the matter generally in the context of the exercise by an administrative agency of its powers. The particulars of three central banks are then examined by way of illustration: the Bank of England, the Bank of France, and the Federal Reserve.

The Right to Sue an Administrative Agency: The Central Bank

General

The administrative law of countries may be classified into two general categories. One category, typified by the United States, the United Kingdom, and countries whose laws derive therefrom, permits judicial review by the same general court system that presides over litigation generally. In such countries, courts of general jurisdiction consider both private causes of actions and those that involve the state.

The second category recognizes a separate system of administrative jurisdiction and law, so that countries with such a system have, in fact, two systems of courts. France was the leader in establishing a separate jurisdiction of courts presided over by the Conseil d'Etat and guided by a body of judge-made law (the ***droit administratif***).[33] Most Western European countries follow the French practice of this parallel jurisdiction,[34] as do non-European countries whose laws are derived from or influenced by the French legal system. In all the systems of law examined, the reviewing court is ordinarily reluctant to substitute its judgment for that of the administrative agency whose action is challenged. The judicial review is thus limited in accordance with the relevant jurisprudence that has arisen under the particular system of administrative law.

United Kingdom

Under English law, several general grounds for judicial review of administrative actions are recognized.[35] The first ground is error of law ("illegality"), where, for example, an agency attempts to exercise authority that it does not possess so that it acts *ultra vires*, or the agency abuses the power that has been entrusted to it. The second ground is unreasonableness ("irrationality"), where the agency exercises a power in an unreasonable manner so as to bring into play the rules of the Wednesbury case,[36] which are concerned with the abuse of discretionary powers. The Wednesbury rules have been summarized as involving four propositions:

> (1) an authority must not be affected by immaterial, or ignore material, considerations; (2) it must direct itself properly in law; (3) it must not act in such a way that it can be said of it that no reasonable authority, properly directing itself to what was material, could have concluded that it was entitled so to act; and (4) in reviewing the acts of an authority the court will not substitute its own view of how a discretion should be exercised for that of the authority entrusted by Parliament with the discretion.[37]

The third ground has sometimes been described as breach of the principles of natural justice, but it appears to involve in practice procedural impropriety, such as failure to follow procedural rules that are expressly prescribed by statute.

The Banking Act 1987 provides a large measure of statutory immunity from liability for the Bank of England. Section 1(4) of that Act states:

> (4) Neither the Bank nor any person who is a member of its Court of Directors or who is, or is acting as, an officer or servant of the Bank shall be liable in damages for anything done or omitted in the discharge or purported discharge of the functions of the Bank under this Act unless it is shown that the act or omission was in bad faith.[38]

Two observations can be made about this provision. First, by its terms, the immunity from liability is not accorded if the act or omission of the Bank was in bad faith. Second, the scope of the immunity extends only to the Bank, its directors, and staff—but not to its agents or to the auditors of the banks.

Section 1(4) of the Banking Act 1987 does not pre-empt the field in its entirety. There is a special procedure for reviewing certain decisions of the Bank of England.[39] These decisions deal with the refusal of an application by an institution for authorization, the restriction or revocation of such authorization, or with a direction by the Bank in connection with the revocation or restriction of its authorization. The institution and affected persons may appeal such decisions to a Banking Appeal Tribunal

consisting of a barrister, solicitor, or advocate who serves as chairman and two other members having accountancy and banking experience. The tribunal decides whether the decision challenged was unlawful or not justified by the evidence on which it was based. It may confirm or reverse the decision but has only limited power to vary it. The tribunal has concluded that this procedure imposes on it a responsibility for forming its own judgments on whether decisions and findings of the Bank were justified by the evidence on which they were based so that, in effect, the Wednesbury tests of unreasonableness do not apply to circumscribe the scope of its jurisdiction. The institution or other person—or the Bank itself—may appeal to a higher court on any question of law arising from the decision of the appeal by the tribunal. If the court considers that the decision was erroneous in point of law, it will remit the matter to the tribunal for rehearing and determination.

Some persons have sought to fasten liability on the banking supervisor by claiming that regulatory activities conducted by it, if improperly performed, may constitute breach of statutory duty, negligence, or the tort of misfeasance in public office. The latter would allow the conclusion that the Bank or its officer was acting in bad faith and, hence, was no longer within the statutory immunity of Section 1(4) of the Banking Act 1987. Two cases are relevant. In *Yuen Kun-yeu v. Attorney General of Hong Kong*[40] and *Davis v. Radcliffe*,[41] when a deposit-taking institution in Hong Kong (in the former case) and a bank in the Isle of Man (in the latter case) failed, depositors who stood to lose as a result of the failure brought suit for damages against the respective supervisory agencies. In the *Davis* case, the theory was that the supervisor's negligence caused damage to the plaintiffs. In the *Yuen* case, the alleged failure of the banking supervisor to exercise reasonable care was supplemented by the assertion of plaintiffs that by continuing to confer a registered status on the failing institution the supervisor had in fact misrepresented its financial condition as creditworthy. In both cases, the Privy Council held for the bank supervisor on the ground that the supervisor owed neither a statutory[42] nor a common law duty to depositors or potential depositors to take reasonable care in the exercise of its powers and duties. These cases were favorably cited by the court in litigation against the Bank of England based on the theory of misfeasance in public office in the aftermath of the failure of the Bank of Credit and Commerce International.[43]

France

In France, as in England, under general principles of law an administrative court will not substitute its discretion for that of the administrative agency. Moreover, the administrative agency is protected from

interference by ordinary courts under the doctrine of separation of powers. A complainant who seeks the annulment of an administrative act may file an application for annulment based on four grounds: (i) incompetence (***incompétence***), (ii) defect in form (***vice de forme***), (iii) violation of law (***violation de la loi***), and (iv) abuse of power (***détournement de pouvoir***).[44] The first of these grounds signifies that the administrative agency lacks the jurisdiction to take the decision in question. The second ground encompasses a procedural irregularity of consequence. In this connection, it is important to note that the Law of 11 July 1979 requires that reasons for administrative decisions be stated in writing and with precision. The third ground arises if the administrative agency violates a provision of a law, regulation, decree, or the general principles of law. The fourth ground involves a consideration of whether the motives that inspired the action of the administrative agency were those that were in the contemplation of the legislature. One authority, comparing English and French law, has characterized the situation as follows:

> It seems that in France the administrative courts will review an administrative act where there has been any of the following forms of misuse of an administrative power:
>
> (a) obstruction to the course of justice;
> (b) fraud on the law;
> (c) some act inspired by a partisan rather than the public interest;
> (d) an act done in the interests of a third party;
> (e) an act inspired by political passion;
> (f) an act inspired by a public interest other than that which caused the creation of the power ("wrong motive").
>
> English law, in spite of sweeping ***dicta*** which can be found in some of the cases, does not yet go as far as this.[45]

Cases have given rise to important interpretative doctrines.[46]

Unlike the Bank of England, the Bank of France does not enjoy statutory immunity from suits. Article 22 of the Law No. 93-980 of August 4, 1993 provides that suits in respect of the internal administration of the Bank or between the Bank and members of the Monetary Policy Council, members of the General Council, or its agents are within the administrative jurisdiction (administrative courts, administrative courts of appeal, and the Conseil d'Etat). Other suits, depending on their nature, may be brought in civil, commercial, or administrative courts. While the Bank of France plays a role, banking regulation and supervision functions are exercised by authorities distinct from the Bank. Notable among these is the Banking Commission. Since the latter lacks legal personality, it is the State's responsibility that would be engaged in the event of liability.

The Conseil d'Etat has recognized, in principle, the liability of the State for a deficient exercise of supervision by the Banking Commission but establishing such liability would require the proof of ***faute lourde*** on the part of the Banking Commission.

United States

Under U.S. jurisprudence, when an administrative agency exercises adjudicatory powers, it performs three tasks. First, it interprets the law that it is charged to implement. Second, it finds facts concerning the situation to which it will apply to law. Third, it exercises discretion in applying the law to the facts. It may be expected that a U.S. court that reviews the adjudicatory action of an administrative agency, like its counterparts in the United Kingdom and France, will tend to treat such action with some degree of deference to its expertise. However, the degree of deference may vary according to the task reviewed. Generally, the U.S. court will be inclined to give less deference to the legal conclusions of the agency than to its findings of fact or the scope of discretion. This is because the court may consider itself as competent as the administrative agency in interpreting law. A court may not enjoy this status in respect to complex fact-finding or technical issues of discretion.[47]

In the United States, specific legislation was enacted in the form of the Administrative Procedure Act of 1946, which sets out the essentials of administrative justice that are binding on all federal administrative agencies and subject to federal court review.[48] The act provides a number of limited grounds on which a court can reverse a decision of an administrative agency.[49] Two clauses deal with questions of law: whether the Constitution has been violated[50] or the agency has exceeded its statutory authority.[51] Two clauses deal with facts: whether the agency's action, findings, or conclusions are unsupported by substantial evidence[52] or (exceptionally, where there is a ***de novo*** trial) whether these are unwarranted by the facts.[53] One clause concerns law, facts, or discretionary matters found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law.[54] Another clause deals with procedural error.[55] In actions against federal administrative agencies that seek relief other than for money damages, the defense of sovereign immunity is waived by express provision of the Administrative Procedure Act.[56] Thus, that defense is not available if the plaintiff seeks to compel the agency to act or to set aside one of its actions.

While tort claims[57] against a federal administrative agency may be brought under the Federal Tort Claims Act,[58] important exceptions to this act bar recovery under its provisions, including where government officials exercise a discretionary function,[59] even if they abuse their dis-

cretion. In one case, the federal regulator of a savings and loan institution removed from its management the chairman of the board, who was also its largest shareholder. Thereafter, the regulator became continuously involved in the institution's business operations. When the deposed chairman sued, charging that the incompetent actions of the regulator had destroyed the institution, the U.S. Supreme Court held that the regulator was protected under the exception from the Federal Tort Claims Act in favor of discretionary acts. The Supreme Court held that this exception encompasses not only acts on a policy or planning level but also day-to-day management at an operational level.[60] It has also been held that the Federal Tort Claims Act modified the sue-and-be-sued doctrines contained in the statutes of particular federal administrative agencies (such as the Federal Deposit Insurance Corporation (FDIC))[61] by making the suit under that act the exclusive remedy for torts, whether covered by the act or excepted from it.[62]

Turning to litigation that has been brought against the Federal Reserve, it is instructive to consider two U.S. cases that dealt with the monetary powers of the central bank. In both cases, the courts protected the monetary powers of the central banks from suit by private parties claiming damage from their exercise. In *Horne v. Federal Reserve Bank of Minneapolis*,[63] the court affirmed the judgment of the lower court that dismissed an action brought to restrain the Federal Reserve Banks from issuing currency on the contention that such issue constitutes coining money in violation of the U.S. Constitution, which leaves this function to Congress. The court affirmed the dismissal on the ground that the plaintiffs had no standing to sue. It stated:

> [C]ases are unanimous which point out that an injury to be justiciable must be peculiar to the particular plaintiff, and not one suffered by all similarly situated persons in common. Absent personal injury or damage, the plaintiffs here do not have the requisite standing to question the constitutionality of the above-referred-to statutes, or any other statutes, in the courts of the United States.[64]

Reference may also be made to *Raichle v. Federal Reserve Bank of New York*,[65] involving the dismissal of a bill in equity to restrain the Federal Reserve Bank from engaging in open market operations and fixing a rediscount rate. The Court of Appeals stated:

> It would be an unthinkable burden upon any banking system if its open market sales and discount rates were to be subject to judicial review. Indeed, the correction of discount rates by judicial decree seems almost grotesque, when we remember that conditions in the money market often change from hour to hour, and the disease would ordinarily be over long before a judicial diagnosis could be made.[66]

Moreover, ***Bryan v. Federal Open Market Committee***[67] involved dismissal for lack of standing of an action challenging the powers of the Federal Open Market Committee.

The principle involved in the cases that test the monetary powers of a central bank is that petitioners must have a direct personal interest in the administrative action that is challenged. They cannot bring an action on a theoretical ground or one that purports to be grounded in the interest of the community generally. This principle is recognized as well by the French Conseil d'Etat. French petitioners who seek to annul an administrative act must show that they have a personal interest in having the act annulled.[68] In the words of one authority:

> The Council of State applies the well-known procedural principle: "No interest, no action." It does not mean to deal with the petitions of persons who, not having any personal interest in the annulment of the challenged act, may have acted out of pure chicanery.[69]

A central bank may also have bank supervisory authority that may be challenged in the courts. In a number of countries, cases have arisen against the central bank or other bank supervisor in which the plaintiff sought recovery on the ground that it was the negligence of the bank supervisor in failing properly to regulate a bank that caused damage to the plaintiff. Sometimes the plaintiff has argued that the banking supervisor should have warned the plaintiff and others in the plaintiff's position about the deteriorating condition of a bank or the irregularities of its business. The response of the supervisor has often been that, because its duty is statutory in nature and limited to the particular objectives of the statute, no duty is owed to the plaintiff. In the United States, this argument is bolstered by the discretionary function exception to the waiver of sovereign immunity referred to above. The outcome of such litigation has mainly been in favor of the bank supervisory agency. By way of example, it has been decided in the United States that in the ordinary course of regulation the Federal Deposit Insurance Corporation owes no duty to a bank or its officers and directors. (However, if the FDIC goes beyond its normal regulatory activities and substitutes its decisions for those of the bank officials, there is some authority for the proposition that it may assume liability).[70] That agency cannot be held liable for failure to warn bank officers and directors about misfeasance that it discovers during its routine inspection.[71] Similarly, it has been held that there is no duty on the bank supervisory agency to warn shareholders[72] or depositors.[73] The issue has been litigated in Germany, initially with a different result. When the German Federal Court of Justice ruled in 1979 that in certain circumstances the Federal Banking Supervisory Office had a duty to protect depositors if it became aware of particular risks,[74] the Banking Act was amended to read[75] that "the

Federal Banking Supervisory Office performs [its] functions . . . in the public interest only."[76]

Central Bank Accountability to the Public

In addition to formal accountability to one or more of the three branches of government, a central bank may have accountability to the public. This accountability may take the form of providing the public with access to information, records, and meetings.

Federal Reserve

In the United States, central bank accountability to the public is maintained in several ways. First, information is conveyed to the public in the form of daily Federal Register notices of proposed rule making, public hearings, and final rules. Weekly statements of the financial conditions of the Federal Reserve Banks are published. A monthly publication includes regulations, statements of policy, interpretations, notices, and orders of adjudications. Second, the public has access to minutes of meetings of the Federal Reserve Board, subject to certain exemptions[77] and after a certain delay in time.[78] In addition, a report on the deliberations of the Federal Open Market Committee is released to the public approximately one month following each meeting.[79] Third, meetings of the Federal Reserve Board are open to the public except where the Board determines that disclosure of information may lead, among other things, to speculation on the financial markets, frustration of a proposed action by the Board, or the instability of a financial institution.[80] Finally, the Board is audited by a public accounting firm, and the report is published in the Board's annual report.[81]

Bank of England

In the United Kingdom, the Bank of England prepares an annual financial report, *Report & Accounts*. The financial statement of the Banking Department generally complies with the accounting provisions of the Companies Act 1985, which is not formally applicable to the Bank.[82] Also, "the statements of account of the Issue Department are drawn up in accordance with provisions agreed between the Bank and HM Treasury to implement the requirements of the Currency and Bank Notes Act 1928 and the National Loans Act 1968."[83] Both the financial statement and the statements of account are reviewed by private auditors.[84] Details of monthly meetings between the Chancellor of the Exchequer and the Governor of the Bank are published within about six weeks.

Together with the annual financial report, the Bank of England publishes a weekly accounting, ***Return***, in the ***London Gazette. Return*** is also displayed in the lobby of the Bank, and available to the public at the Bank.[85] The Bank also publishes a quarterly ***Inflation Report,*** which is an account of the factors that may affect inflation and an analysis and projections underlying the Bank's advice to the Chancellor on monetary policy,[86] as well as the ***Quarterly Bulletin,*** which is a collection of research papers on monetary analysis.[87] In addition, the Bank submits to the Chancellor of the Exchequer and publishes an annual report on its supervisory activities, copies of which are laid by the Chancellor before Parliament.[88] Since April 1993, the minutes of the monthly meetings between the Chancellor and the Governor have been published. The initiative for this change came from the Treasury Department, but a report from the Treasury and Civil Service Select Committee on the role of the Bank of England also called for the change.[89] However, it is the Chancellor, not the Bank's Governor, who is responsible for explaining changes in interest rates to the public.[90]

Bank of France

In France, the Bank of France publishes weekly statements on its financial position in the ***Journal Officiel,*** pursuant to the requirement to do so set forth in Article 34 of the central bank act. Furthermore, the public has access to information prepared by the Bank of France and published by the Minister of Economic Affairs and Finance regarding the balance of payments and net external position of the country. The Bank also publishes the ***Bulletin de la Banque de France*** and other periodicals.

Conclusion

Evolutionists recognize a principle called ***evolutionary convergence***.[91] In accordance with this principle, different families of animals, although genetically distinct, may tend to evolve representatives that resemble one another in function when faced with the same external stimuli. It is submitted that the principle of evolutionary convergence may apply to central banks, as well. Central banks are related to each other in some general ways: they are all administrative agencies separate from the traditional three branches of government but possessed of a blend of powers appropriate to the tasks assigned to them. Although not all these tasks are the same for each institution, they share enough of them to create similarities of organization and function. The execution of common tasks requires them to confront similar external factors. This activity produces recognizable patterns of behavioral response common to central banks. It is submitted that these institutions may then be able to anticipate from the

experience of their peers certain patterns that are likely, in time, to become their own.

One important direction in which contemporary central banks are being drawn is toward greater autonomy. However, this movement carries a corollary that can be delayed, if at all, only for a limited period of time. The accepted corollary of autonomy is accountability (and the transparency that this implies).[92] The process has affected more than one central bank and, it is submitted, will continue to affect them all. While accountability must inevitably accompany autonomy, it may do so in ways that need not compromise the essentials of either. It may be instructive to consider the views of the U.K. Select Committee on Nationalized Industries some years ago in counseling to the Bank of England a publication of full accounts:

> Your Committee regard it as wholly inappropriate that a public body should be accountable to nobody. The Bank's argument that the Court [board of directors] is responsible for the proper running of the Bank appears to miss the point. It is not enough that "a highly responsible body" such as the Court [board of directors] "each and every member of which is appointed on the recommendation of the Prime Minister" should control what the Bank does. . . . The Governor said that the Court of the Bank was responsible to the country for the proper conduct of the Bank . . . but up to now the country has been quite unable to judge whether the Bank has been properly conducted. . . .[93]
>
> Other central banks publish accounts in varying degrees of detail. Other central banks enjoy varying degrees of independence. Your Committee have no reason to believe that the degree of independence enjoyed by central banks is in inverse proportion to the amount of information they publish about their accounts: the two factors are quite unconnected. Your Committee fail to see how the publication of accounts by the Bank of England could in any meaningful way damage the Bank's independence. Publication in itself would not deprive the Court of the responsibility, given it under the Act, for the organisation of the Bank, its staffing, its methods of working, its investment policy, and its relations with its customers.[94]

The movement toward accountability can only be accelerated by the plethora of banking innovations and developments that central banks must address as the century draws to a close. It is unlikely that any central bank can guarantee that its approach to each of these developments will be unassailable. Its decisions and their consequences must be perceptible to, and challengeable by, the public, debatable in parliament, and, reviewable if necessary in courts or other appropriate forums of redress. It is with this consideration in mind that this volume explores some of the leading developments, both systemic and particular.

The subjects treated in this volume attempt to place the central bank in the contexts of rapidly changing developments. The contexts, in a decreasing order of magnitude, include developments at the level of the international financial institutions, on the regional level in the European Community and NAFTA, and then at a country-specific focus. An important current theme is explored: bank supervision. It is pursuant to this authority that the central bank is most likely to encounter the rapid innovations that are sweeping the banking industry. Finally, topics reflecting recent innovations of special interest to central banks are explored in the areas of payment systems, securities transfers, foreign exchange trading agreements, derivatives, and securitization.

This volume is the fourth in a collection of revised proceedings of seminars that have been sponsored by the International Monetary Fund's Legal Department, in conjunction with the IMF Institute, for general counsels of central banks. The volume, which reflects topics originally addressed at the 1994 seminar, contains the collected views of many of the foremost thinkers and actors in the field of banking, having particular reference to the legal aspects of the matters discussed. Following the main papers of the proceedings are the remarks of a number of distinguished commentators. Each of these commentators offers a distinct perspective on a given subject. The views expressed in the various papers and commentaries are those of the authors and should not be interpreted as reflecting the views of the International Monetary Fund or any other institution.

* * *

Mr. Gianviti begins by tracing the history of the International Monetary Fund from its roots in the United Nations Monetary and Financial Conference of 1944; in this connection, he mentions the three amendments of the Fund's Articles of Agreement. The focus of his chapter concerns features that make the Fund different from other organizations. He points out that international organizations gradually tend to expand their activities, and consequently, it becomes increasingly difficult to define an organization's mandate and to tell what makes it different from others. Some of the distinctions between organizations can be attributed to their charters, while others are the result of practice. He provides two examples that illustrate how the Fund is different: (i) its provision of financial assistance to its members; and (ii) the nature of state succession in the Fund. With respect to the first example, the Fund's financial assistance to its members is subject to different rules, depending on whether the resources are from the General Resources Account (available to all members), the Special Disbursement Account (available, in fact, only to developing countries with the lowest per capita income), or

Administered Accounts (available for the specified purposes for which the account was established). Using the General Resources Account as a model, Mr. Gianviti identifies three themes that illustrate unique aspects of the Fund as a financial institution. First, the purpose of the Fund's assistance is to help member countries solve their balance of payments problems while avoiding recourse to exchange restrictions on current international transactions that might tempt a member faced with a shortage of foreign exchange. Second, the technique by which the Fund provides assistance in the General Resources Account is not in the form of loans but rather in the form of exchanges between the requesting member's currency and an equivalent amount of either another member's currency or Special Drawing Rights. Third, whether the Fund authorizes a purchase or approves a stand-by arrangement, the use of its resources is subject to conditions that are related to the purpose of the assistance, namely, to solve the member's balance of payments problems without resorting to measures destructive of national or international prosperity. In addition, the conditions are also intended to safeguard the Fund's resources. Turning to the second example of a specific legal feature of the Fund, Mr. Gianviti notes that in the history of the Fund there have been several cases of changes in the legal status of members when, for example, a member has absorbed a nonmember, a member has merged with a nonmember, or two members have merged. However, he points out that more difficult problems can arise when territories within a member state become independent. This may occur through secession from, or even dissolution of, a member. In the absence of any explicit provision in the Articles of Agreement on state succession, he notes that innovative answers to the questions raised by state succession had to be developed. In this connection, he describes the dissolution process by which successors of the Socialist Federal Republic of Yugoslavia and those of Czechoslovakia were deemed to have continued the membership of their predecessors in the Fund.

Mr. Holder considers the relationship between the International Monetary Fund and the United Nations. He notes that both the UN and the Fund are subjects of international law with explicitly conferred legal personalities. He reviews the negotiating history and analyzes provisions of the Agreement Between the United Nations and the International Monetary Fund, which came into force on November 15, 1947. He points out that, although the Fund is a specialized agency within the meaning of the UN Charter, it is not a specialized "agency" (or agent) of the UN. He emphasizes that influence on the decisions of the Fund by political bodies is not countenanced. He describes how the Fund's independence was put to a test in the case of its relations with one of its members. Mr. Holder explains that, in its deliberations and communications

in this case, the Fund took the position that all organs of the Fund were required to adhere to the Articles of Agreement. Under the Articles, the rights of a member must be respected, including the member's entitlement to use Fund resources, in accordance with Fund policies on the use of Fund resources and subject to the decision of the Executive Board. He explains why the Fund is not obligated to carry out the decisions of the UN Security Council. He then considers why the Fund is exempt from having the UN review its budget. Mr. Holder also describes how the two organizations cooperate in areas such as reciprocal representation, consultations and recommendations, and exchange of information. In addition, reference is made to a special report that in part discusses the relationship of the Fund and the UN.

Mr. Munzberg focuses on specific issues regarding the Special Drawing Right (SDR). He notes a proposal for an allocation of SDRs and the possibility of targeting increased amounts of SDRs to particular groups of members, specifically new members of the Fund. He describes this renewed interest in the SDR as a positive development. Mr. Munzberg surveys the history of the SDR, noting that the SDR Department was created a quarter of a century ago through the First Amendment of the Articles of Agreement and that the Second Amendment added to the Articles the objective of making the SDR the principal reserve asset. He then considers the proposal for a general allocation and the reasons justifying such an allocation. He notes that the needs of individual members or groups of members do not justify an allocation. Instead, it is the need of the world economy as a whole for supplementation of reserves that forms a basis for an allocation of SDRs. Mr. Munzberg explains why a proposal was made, but not adopted, to cancel all or part of the existing SDRs and then to allocate at least the equivalent amount of SDRs on the basis of current quotas. He notes that the Fund continues to study how to increase the amount of SDRs and make available SDRs to all member countries.

Mr. Rigo considers the Global Environment Facility (GEF), which, without a legal personality of its own, is intended to provide an umbrella for cooperation between existing organizations. This facility promotes the financing of projects that are deemed to benefit the global environment. It was restructured and given a permanent status in 1994. He states that the GEF was initially an experiment of international cooperation to finance activities for enhancing the global environment. He notes that the GEF's unique features make it an interesting case study of an international organization. The issues that arise include how existing structures are used to achieve new objectives, how they are modified in the process, and how new structures come into being. He describes the pilot phase of the GEF; the roles of the International Bank for

Reconstruction and Development, the United Nations Development Program, the United Nations Environment Program, and participating states in the GEF; and the funding of the GEF. He mentions the Montreal Protocol and the establishment of the Interim Multilateral Fund, which was created to assist developing countries in meeting their obligations under the Protocol. He points out that, as early as 1992, the participants of the GEF agreed that its structure should be adjusted to play a permanent role beyond the pilot phase. Mr. Rigo concludes by describing the two-year negotiating process that established the permanent GEF, the instrument negotiated, and the GEF structure, including its Assembly, Council, and Secretariat.

Ms. Sullivan provides an overview of developments at the International Finance Corporation (IFC). The IFC, a member of the World Bank Group, promotes development in its member countries by supporting the private sector. It is the world's largest source of direct investment for private project development in developing countries, lending money to, and investing its funds in, such projects, as well as helping to mobilize funds from other lenders and investors. Ms. Sullivan notes that the worldwide trend of moving away from government control of the economy and toward greater encouragement of private initiative and the development of a viable private sector has confronted the IFC with a special challenge and a special burden. She discusses the IFC's role as a project investor and its function as a mobilizer of resources. Ms. Sullivan notes that the IFC provides technical assistance to economies in transition. She provides examples of assistance in privatization projects and financing of basic infrastructure projects. Finally, using a power project as an example, she discusses the risks involved: foreign exchange risk, commercial risks, and political and governmental risks.

Mr. Newburg examines some of the legal issues that have arisen during the early years of the European Bank for Reconstruction and Development's existence. First, he distinguishes the Bank's charter from those of other international financial institutions. He notes that the Bank has a unique mandate: to support the transformation of the countries of Central and Eastern Europe into market-oriented democratic societies while promoting in all of its activities environmentally sound and sustainable development. Second, he addresses the issues arising from changes in the countries constituting the Bank's membership. Issues relating to eligibility for membership and the dissolution of the U.S.S.R., Yugoslavia, and Czechoslovakia are discussed. Third, he examines the private sector focus of the Bank's charter. In particular, Mr. Newburg points out that the Bank's charter imposes quantitative constraints on its state sector operations by requiring that not more than 40 percent of the Bank's resources be committed to the state sector of the recipient coun-

tries as a whole during the first two years of the Bank's operations and during each fiscal year thereafter. Then, he analyzes the Bank's relationships with other international financial institutions, specifically focusing on the coordination of the Bank's policies and the World Bank's negative pledge clause. Mr. Newburg closes by stating that, in order for the European Bank for Reconstruction and Development to serve its object and purpose, it will continue to be necessary to adapt its legal norms to the rapidly changing environment in which it operates.

Ms. Lichtenstein analyzes how the European Monetary Institute (EMI) has been charged to prepare for the third stage of European Monetary Union, which is to occur not later than January 1, 1999, and what authority it may or may not have over the national central banks of the member states of the European Union. She concurs with others who would characterize the role of the EMI as more of a power of influence than a power of decision. Her central thesis is that the European System of Central Banks (ESCB), which will comprise the European Central Bank and the national central banks after the third stage begins, will not be a "system" at all. She argues that it will be a Union central bank, a Community organ, with "lawmaking" powers and access to the Court of Justice of the European Communities to enforce its law. The national central banks retain their competences in the field of monetary power during the second stage. Thereafter, they will, in effect, become its branches. She begins her analysis by discussing the structure of lawmaking and enforcement within the European Community. Next, she explains how the Treaty on the European Union fits the ESCB into this structure as the European Union's independent central bank for monetary policy. She notes that the ESCB's control over monetary policy does not extend to prudential supervision. The latter will remain within the jurisdiction of the national central banks or other national authorities. Finally, Ms. Lichtenstein concludes by examining how the Treaty provides for the situation in which the third stage of European Monetary Union may begin for some member states but not others, and the special provisions for Denmark and the United Kingdom.

Mr. Smits begins with some introductory statements on the European Community and its legislative process. He explains that the European Union, as the major organization for European economic and political integration is now called, is the current end result of a process of nation building that started after the Second World War. Then, he reports on the development of the European Economic Area, which is composed of the member states of the European Community and the member states of the European Free Trade Association. The European Economic Area brought the economic integration of the continent closer. Turning to the focus of his paper, he states that the Second Banking Directive is the cor-

nerstone of the internal banking market. Moreover, it sets the tone for similar directives in the area of insurance and securities trading. Mr. Smits analyzes the content of the First and Second Banking Directives and refers to the complementary solvency ratio and Own Funds Directives. He addresses the concepts of home and host state supervision, as well as other aspects of the directive, including the concept of a credit institution, the six conditions for obtaining and maintaining a banking authorization, reciprocity, and the "European passport." He also addresses the harmonization of supervisory rules regarding minimum capital, the suitability of shareholders, the limitations on banks' involvement in commercial companies, the need for adequate administration and internal controls, and the establishment of branches and provision of services. In addition, he surveys cooperation among bank supervisors. Finally, Mr. Smits addresses some of the Second Banking Directive's flaws and proposed remedial amendments to the directive.

Mr. Clarotti provides a detailed analysis of the European Community's directives on deposit guarantee schemes and money laundering. First, however, he addresses the fundamental principles of banking legislation in the European Community, including the necessity of creating a level playing field for all types of financial institutions. Then he describes the legislative history of the directive on deposit guarantee schemes and the adoption of such schemes by various member countries. He notes that there are two essential justifications for the creation of such schemes: first, the need to protect the depositors, and second, the need to ensure the stability of each bank and the banking system in general. Various specific issues that needed to be resolved during the legislative process are addressed. For example, he mentions the various levels of protection offered by the member states and discusses how a compromise solution was reached. Turning to the directive on money laundering, he begins by pointing out that in 1990 the laundering of drug money did not constitute a crime in any member state other than the United Kingdom. He states that the European Commission was aware of the danger that money laundering presented for the soundness and stability of the European financial system and had started preparatory work during a period when international efforts to combat money laundering were increasing. He restates three objectives of the directive: to prevent criminals from taking advantage of the single internal market to carry out money-laundering operations; to avoid member states adopting restrictive measures inconsistent with the single market; and to contribute, within the limits of its competence, to opposing organized crime in general and drug trafficking in particular. Lastly, Mr. Clarotti analyzes important provisions of the directive, including the definition of money laundering and bank secrecy.

Ms. O'Day addresses the General Agreement in Trade in Services (GATS) and how it may affect banking services. First, she explains why the Board of Governors of the Federal Reserve System, together with other U.S. regulators, thought it important to be involved in the actual negotiations on the agreement relating to trade in services. She notes that the Uruguay Round of General Agreement on Tariffs and Trade (GATT) negotiations represents the first time that trade in services was to be brought within a multilateral agreement. She states that the purpose of the exercise was to achieve greater liberalization in the service sectors. Ms. O'Day identifies three major areas of concern: (i) the need to take account of a country's right to take necessary actions to protect its banks, its depositors, and the financial system generally; (ii) the enforcement mechanism in the GATS provisions; and (iii) the traditional GATT practice of allowing for retaliation for violations of the agreement. Next, she describes the main features of the GATS as they relate to financial services, including the most-favored-nation concept, the dispute settlement process, the financial services annex, and the understanding on financial services. Ms. O'Day concludes by addressing the implications of the GATS for banking services and for regulators and central banks.

Mr. Palzer analyzes the legal issues arising for central banks under Chapter Fourteen of the North American Free Trade Agreement (NAFTA). First, he considers how the NAFTA legal regime governs banking services and banking regulations. He distinguishes between the two types of activities in financial services covered by NAFTA: investment in financial services, and cross-border trade in financial services. Then he reviews NAFTA's five basic rules that govern financial services: (i) national treatment; (ii) cross-border trade in services; (iii) most-favored-nation treatment; (iv) new financial services and data processing; and (v) senior management and boards of directors. Following a discussion of supplementary rules that apply to financial services, he examines how NAFTA might promote integration in the financial sectors of the NAFTA countries. Thereafter, he considers provisions of NAFTA bearing on dispute settlement between states and between states and investors. In conclusion, Mr. Palzer observes that the first and most important lesson that central banks can draw from Chapter Fourteen of NAFTA is that of policy emphasis: the U.S. Government has placed financial services on the trade policy agenda and may be expected to press for the achievement of open markets in the sector.

Mr. Guardia surveys recent developments in banking law and practice in Latin America. First, he provides a historical background against which the significance of the developments can be recognized. Next, he examines key developments in central banking law, including the redefinition of the role of the central bank, the rediscovery of central bank indepen-

dence, the need for accountability, and the key functions of a central bank. Mr. Guardia then reviews developments in bank supervision that have been prompted by the liberalization of the financial system, growing technological advances, and the integration of world financial markets. He closes by stating that the most interesting legal development in Latin America is the philosophical change that is taking place: the new approach toward central banking legislation is market oriented and favorable to the development of a free, competitive, and efficient financial system that may assist in the integration of that system with the larger partners in the world economy.

Mr. Mattingly describes the role of the Board of Governors of the Federal Reserve System in implementing the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA). He states that the statute was intended to create uniform federal standards for the supervision and regulation of foreign banks in the United States and ensure that foreign and domestic banks were regulated consistently. He notes that the principal requirements contained in the FBSEA (enhanced supervision and increased examinations by a federal regulator, and a demonstration that non-U.S. banks are subject to comprehensive supervision on a consolidated basis) are equivalent to requirements imposed on U.S. banks. He points out that the FBSEA permits the Federal Reserve to terminate the activities of a non-U.S. bank's branch, agency, or commercial lending company if the non-U.S. bank is not subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. He discusses the FBSEA's application process and the program for supervising and examining foreign banks. Mr. Mattingly concludes by noting that the Federal Reserve is attentive to its responsibilities under FBSEA because, as financial markets become more integrated, foreign banks will have an increasing influence on the U.S. economy.

Mr. Rose, in the paper presented by him, reports that national deposit insurance has worked to promote banking stability. After a brief explanation of the structure of the U.S. bank regulatory system, he relates the history of the Federal Deposit Insurance Corporation (FDIC) from its creation in 1933 to the present. He notes that the history of the FDIC cannot be considered apart from changes in economic and banking conditions. He reviews the conditions that caused bank failures during specific periods. For example, he notes that conservative banking practices and favorable economic conditions resulted in few bank failures during the late 1940s and 1950s. However, he points out that as the 1980s began several factors undermined the traditional approaches to profitability for the banking industry, resulting in an increase in bank failures. He discusses the problems that the banking legislation adopted by the U.S. Congress during the 1980s and 1990s sought to remedy. Mr. Rose

surmises that, although no one can predict what specific role the FDIC will play in the years to come, the FDIC will continue to adapt to the changing economic conditions and shifts in the banking environment in order to protect insured deposits with minimal disruption to the U.S. economy and financial markets.

Ms. Bettauer discusses how the Office of the Comptroller of the Currency (OCC), which has been supervising banks for 130 years, is engaged in changing bank supervision. She points out that, as society and the economy evolve, banking and banking supervision must also evolve. She discusses this evolution and focuses on the OCC's approach to bank supervision. In conclusion, Ms. Bettauer asks, "What does the future hold for banking?" Her response is that the OCC wants to ensure that the future promises a system of bank supervision that addresses the growing complexity and technical sophistication of the industry.

Ms. Buck elaborates on several current legal issues concerning the regulation of the U.S. savings and loan industry. She explains the recent evolution of the thrift industry from one in which many savings associations were insolvent to the current state of general profitability. During this transition, the industry became smaller. She describes the new enforcement policy of the Office of Thrift Supervision (OTS) in regulating a sounder and smaller thrift industry, which was adopted in response to the changes. This policy puts greater emphasis on recovery by way of restitution from persons responsible for thrift failures, on the prohibition of unsuitable persons from participating in the thrift industry, and on cease and desist orders to correct practices. Next, Ms. Buck provides an overview of five key changes that were made to the OTS's regulation of mutual savings associations that wish to convert to the stock form of ownership. Again, she notes that these changes in regulation were prompted by the changed condition of the industry, in which profitable mutual associations are seeking to convert into stock associations in order to raise capital for expansion or for stock benefit plans for management and employees. Finally, Ms. Buck reviews the OTS's regulation of the sale by savings associations of uninsured products, such as mutual funds and annuities, and the need for proper disclosure to customers.

Ms. Morales Marks discusses certain initiatives taken by the U.S. Treasury Department with respect to the provision of financial services. She begins with an analysis of proposed legislation to provide for fair trade in financial services. Proposals for such legislation relate to the Uruguay Round negotiations and bilateral discussions on financial services between the United States and other countries. One such bill provides the Secretary of the Treasury with the power to withhold future expansion and benefits to financial firms based in nations with restrictive

barriers to trade in financial services. Next, she addresses the rationale for the enactment of interstate banking and branching legislation, which generally removes the geographic restrictions that had traditionally been imposed on banks in the United States. She then turns to a proposal to consolidate the four U.S. federal banking agencies, considering the structure and possible benefits of such a consolidated agency. Finally, she mentions work in progress to address risks posed by over-the-counter (OTC) derivatives. Ms. Morales Marks concludes by stating that the U.S. Treasury Department has a careful approach calculated to remove obstacles to the flow of credit and make the U.S. system operate efficiently. Furthermore, the Department will seek achievable goals to prepare the U.S. banking system for the challenges of the next century.

Mr. Blair reviews some of the more important recent developments in the banking law of the United Kingdom. He points out that in the last decade the most pronounced development in U.K. banking law has been the growth in the formal body of regulatory law. In particular, he focuses on changes in the structure of regulation, including the role of the Bank of England, the regulation of investment business under the Financial Services Act 1986, and the implementation of European Community banking directives. In addition, specific issues regarding the duties of auditors, derivatives, setoff, money laundering, and environmental liability are addressed. He examines how the courts have increasingly emphasized basic consumer rights. He addresses the protection of guarantors, legislation against unfair contract terms, and the Code of Banking Practice. Lastly, Mr. Blair studies three issues concerning banking contracts in the United Kingdom: jurisdiction, governing law, and the effect of governmental sanctions.

Mr. David surveys developments in the Canadian financial system. First, he examines the institutional structure of the financial system. He notes that traditionally regulation was based on institutional lines, with functional and investment prohibitions aimed at preserving distinctions between the various financial service providers. However, while the institutional classifications have been preserved for regulatory purposes, the functional restrictions have largely been eliminated. This elimination occurred by allowing financial institutions overlapping core powers and permitting banks to own or control investment dealers, trust companies, and insurance companies. Second, he overviews foreign access to the system in the light of (i) the amendments to the Bank Act that allow foreign financial institutions to incorporate Canadian bank subsidiaries and (ii) NAFTA. Third, he discusses financial-commercial linkages in the system, in particular the holding of bank shares by commercial enterprises and investments in commercial enterprises by banks. Commercial entities are generally constrained from holding more than 10 percent of the shares of a bank while financial insti-

tutions are prohibited from having equity investments in excess of 10 percent in the shares of any commercial enterprise. Finally, he addresses solvency, deposit insurance, and consumer protection. Mr. David concludes by noting that the general thrust of recent Canadian legislative and regulatory policy has been to re-examine traditional regulatory approaches and to strengthen internal governance regimes. The latter objective involves provisions in the law intended to avoid conflicts of interest, strengthen the role of the external auditor, adopt a prudent investor standard, and increase the responsibility of directors.

Mr. Shea examines some of the developments in banking laws in the Baltic countries, the Russian Federation, and the other republics of the former Soviet Union. He describes the types and number of banks operating in the region. He also mentions the embryonic securities market and the role of the central bank in bank funding. While the practice has been changing, most bank funding had come from the central bank, which channeled funds through commercial banks to particular state enterprises. He discusses the need to improve specific prudential rules governing banks, including rules governing capital, bank ownership, and risk recognition. In conclusion, Mr. Shea proposes reform measures that could be taken to deal with problems in the banking system. Among his suggestions are better prudential rules; substantial recapitalization; new banking laws; bank closures; good accounting rules and practices; laws on collateral for lending, bankruptcy, and payment systems; and dispute resolution procedures.

Mr. Asser addresses banking law reform in the People's Republic of China. He first comments on the task of law reform in a society that is in transition from a command economy to a market economy. He points out that for the transition to be successful changes must be made not only in economic thinking but also in legal thinking. Next, he examines the functional differences between the banking law in a command economy and a market economy. He explains that, in order to exercise freedom of economic decision making in China's new socialist market economy, the banks in China should be independent entities under the law. Both banks and the People's Bank of China, the bank regulator, should have juridical personality and full operational independence under the law. However, establishing such independence by law is not sufficient. Economic practices must change as well. He addresses the need for policy reforms in China's banking sector and focuses on policy-based lending. Lastly, Mr. Asser reviews issues regarding institutional, operational, and related legal reforms in the financial sector.

Mr. Promisel examines the general issues associated with the role of the central bank in bank supervision and regulation and why it is impor-

tant that central banks should be involved in these matters. First, he emphasizes that it is the fundamental responsibility of central banks to ensure (i) monetary stability and (ii) the stability of financial markets, although each central bank may have a somewhat different mandate and objectives. Monetary stability involves the stability of the price level and the value of the currency, while the stability of financial markets relates to the institutions in the financial sector, the players, the structure of the financial markets, the infrastructure, and financial market prices. While the central bank need not invariably have a supervisory role over financial institutions, Mr. Promisel believes that it has been important in the U.S. experience. In addition, he describes other functions of a central bank, including (iii) management of the payment system, (iv) lender of last resort, and (v) crisis management (including its international aspects). Finally, Mr. Promisel mentions how the risks posed by derivatives and hedge funds are being monitored by central banks.

Ms. Roberts addresses central bank involvement in banking supervision, primarily in the Group of Seven (G–7) countries. She provides an overview of a review of supervisory practices in the G–7 countries compiled by the Board of Governors of the Federal Reserve System. While most of these central banks are involved in bank supervision to a greater or lesser extent, the specifics of the involvement vary from country to country. She describes each of the nine specific areas relating to banking supervision and regulation that were addressed: (i) the legal basis for supervision; (ii) the agencies involved in banking supervision; (iii) the chartering responsibilities; (iv) the examination authority; (v) the reliance on external audits; (vi) statistical reporting and surveillance; (vii) corrective measures and sanctions; (viii) the responsibility for rule making; and (ix) deposit insurance. The findings for each of the G–7 countries are summarized by Ms. Roberts.

Mr. Giddy evaluates the merits of a country's having an independent agency for the supervision of banks, as compared to housing the bank supervisory function in the central bank or the finance ministry. He argues that an independent agency is in the best interests of depositor safety and bank efficiency because it leaves the central bank free to concentrate on its proper function—monetary policy. He divides a government's interest in the banking system into three public policy objectives: controlling the volume of liquidity, protecting the integrity of the banking system, and ensuring the availability of credit. He describes a division of labor among the central bank, the bank supervisor, and the finance ministry. Mr. Giddy matches the public policy objectives with the functions of these three agencies, explaining that when the functions are confused things tend to go awry. He then examines bank supervision and the central bank as lender of last resort; deposit insurance and the need to

counter moral hazard incentives; prudential regulation; the behavior of regulators; and the U.S. debate as to where bank supervisory authority should lie. He notes that the argument in favor of an independent supervisory agency runs along the same lines as the argument for an independent central bank. In conclusion, Mr. Giddy surmises that, in an ideal world, the bank supervisory agency would be separate and independent and have the sole function of administering liability-side prudential regulation.

Mr. Wahlig provides a German perspective on who should be the banking supervisor. He defines the objectives of banking supervision and compares these objectives with the goals of monetary policy and the tasks of the central banks. Then he examines whether central banks may be exposed to conflicts if they are ultimately responsible for banking supervision, as well as serving as lenders of last resort. Next, he describes the system of banking supervision in Germany and explains the interaction between the Federal Banking Supervisory Office, which is responsible under the law for banking supervision, and the Deutsche Bundesbank, which is extensively involved in banking supervision in practice. Lastly, Mr. Wahlig mentions the role of the projected European Central Bank in banking supervision.

Mr. Sparve offers a Swedish perspective on who should be the banking supervisor. He identifies two major models for banking supervision: supervision conducted by the central bank and supervision conducted by an authority separate from the central bank (either in the ministry of finance or a supervisory authority under the government). He surveys which of the models exist in several Organization for Economic Cooperation and Development countries. Mr. Sparve points out that, in all cases where the main responsibility for supervision is outside the central bank, a close exchange of information and cooperation between the responsible authority and the central bank exist. In addition, he notes the tendency to move supervision closer to the central bank. Next, he turns to the advantages and disadvantages of transferring banking supervision from a separate authority to the central bank. Mr. Sparve draws the following conclusions: (i) the choice of banking supervisor is not a crucial issue; (ii) there is no need for a country to reformulate its structure unless there is a specific need; and (iii) if a country were to build a new system, the central bank model should be recommended.

Mr. Milleret provides a French perspective as to who should be the banking supervisor. He begins by examining the legal framework for banking regulation and supervision in France. He describes the establishment, composition, and tasks of the regulatory and supervisory authorities, namely, the National Credit Council, the Banking Regulations

Committee, the Credit Institutions Committee, and the Banking Commission. Then, he examines the independence recently granted to the Bank of France. In particular, he describes its two governing bodies: the Monetary Policy Council and the General Council. In addition, he explains changes in the Bank of France's relations with the regulatory and supervisory authorities. Mr. Milleret closes by stating that the Bank of France plays an essential role in banking regulation and supervision, although these functions are fulfilled by authorities that are distinct from the Bank of France.

Mr. Baxter, in the paper presented by him, examines the lessons that bank supervisors can learn from the failure of the multinational bank known as the Bank of Credit and Commerce International (BCCI). He provides answers to the following five questions: (i) What happened? (ii) How did BCCI occur? (iii) Why are these events important to banking supervisors? (iv) What can be done to prevent a recurrence? and (v) What lessons can be learned from the failure of BCCI? He explains the financial and human costs. He identifies factors in six categories that led to the failure: (i) fractured supervision; (ii) irrational corporate organization; (iii) corporate culture; (iv) authority; (v) representation; and (vi) technology. Mr. Baxter describes international initiatives to improve international cooperation among bank supervisory authorities and domestic legislation concerning foreign bank operations in the United States. Specific actions taken in the course of criminal prosecutions and civil enforcement of banking laws in the United States are reviewed. Mr. Baxter concludes by noting that perhaps the most important lesson from BCCI's failure is that bank supervisors can no longer limit their supervision and regulation of banking organizations to their own geographic boundaries.

Professor Barth, in the paper presented by him, considers the role of deposit insurance in the United States. He points out that the large number of costly depository institution failures and the changing role of depository institutions in the U.S. financial marketplace have raised many questions: What caused all the failures and the huge resolution costs? Why are depository institutions losing market share? Are depository institutions becoming obsolete? Should the federal government provide financial stability through deposit insurance, given the evolving environment? He describes the turmoil in the U.S. banking system over the past 15 years. Then, he addresses the erosion in market share experienced by U.S. banking institutions over the same period. In addition, he explains why the failures were so numerous and costly and why market shares have evolved as they have. Professor Barth identifies the key aspects of the present U.S. regulatory system and their effect on the evolution of the U.S. banking system. He considers several options for the reform of deposit insurance.

Two of these options would eliminate deposit insurance by establishing (i) the narrow bank concept, in which assets would comprise short-term government securities and liabilities would be demand deposits or transaction accounts, and (ii) a variation of the first proposal that would include the establishment of a federal government money market mutual fund. Lastly, he considers the implications of the U.S. banking experience for the evolution of financial and regulatory institutions.

Mr. Atiyas addresses the importance of bankruptcy laws, citing their role in the development of financial markets and industrial restructuring policy. He notes that most bankruptcy laws prescribe variants of two distinct procedures: liquidation, and reorganization of the insolvent debtor. He discusses market imperfections that provide the economic rationale for the existence of bankruptcy and reorganization policies. Then, Mr. Atiyas compares the bankruptcy laws of the United States, the United Kingdom, and France. He believes that (i) the U.S. law may tend to favor the debtor, (ii) the U.K. law may tend to favor creditors (particularly secured creditors), and (iii) the French law grants substantial decision-making authority to the court rather than to debtors or creditors. Thereafter, he offers some thoughts on bankruptcy policies for developing countries, where the law may be outdated. He cautions against giving banks a dominant role in bankruptcy procedures. Mr. Atiyas concludes by noting that reform of the bankruptcy system alone is ineffective unless undertaken as part of a general overhaul of the regulatory environment in which restrictions on the mobility of capital and labor and inadequacies in the social safety net are addressed.

Mr. Whelan analyzes important elements of Chapter 11 of the U.S. Bankruptcy Code. This innovative chapter has as its objective the rehabilitation of the debtor through reorganization rather than the liquidation and distribution to creditors of the debtor's assets. He notes that the filing of the bankruptcy petition triggers the imposition of an automatic stay of proceedings, which creates a court-imposed moratorium on adverse actions against the debtor and the debtor's property. He mentions the appointment and role of the unsecured creditors' committee. He then describes some of the rights of the debtor in possession, including the right to reject or assume executory contracts or unexpired leases; the right to avoid or annul certain prepetition transactions; the right to use, sell, or lease property of the estate; the right to obtain secured or unsecured credit; and the right to secure turnover of property of the estate that was seized by creditor process prior to the Chapter 11 case. The countervailing rights of creditors are also mentioned. Mr. Whelan also addresses the process by which the debtor's reorganization plan is confirmed, as well as the statutory requirements that the plan must satisfy before the bankruptcy court. He states that the framework of Chapter

11 is based on several important legal principles that, on balance, protect both the debtor and the creditors. Mr. Whelan concludes that the rehabilitative provisions of the bankruptcy law have not only resulted in successful reorganizations but have also saved countless jobs, provided a significant return to creditors, and enabled debtors to preserve the going-concern value of their businesses.

Mr. Schiffman first analyzes aspects of bankruptcy law in Eastern Europe. Providing examples from the bankruptcy laws of the Czech Republic, Hungary, and Poland, he focuses on the following aspects: administrative efficiency, the stay of related proceedings, the degree of finality of proceedings, enterprise rehabilitation, the avoidance of pre-bankruptcy transfers, and priorities in the distribution of assets. Second, Mr. Schiffman examines bank insolvency law in Eastern Europe. He critiques certain methods of providing for the initiation of insolvency proceedings against a bank. He discusses how one law sets forth two stages. In the first stage, when a marked reduction in capital occurs, the central bank tries to find a buyer for the bank. In the second stage, if the bank declares that it is insolvent or if the central bank so determines, a court takes over the process and initiates bankruptcy proceedings. Mr. Schiffman considers whether a country's bank insolvency law should be consistent with its general bankruptcy law.

Mr. Emert discusses how the new master netting agreements for foreign exchange can help to reduce systemic risk. Focusing on the International Foreign Exchange Master Agreement (IFEMA), he provides information about the characteristics of the foreign exchange market, the development of the master netting agreements, the variety of possibilities for their use, and a view of how the market is working to solve these problems. A master agreement, he explains, represents not one transaction but a number of transactions that are all subsumed under one contract. The principles underlying the master agreement and associated close-out provisions of foreign exchange agreements are intended to permit a nondefaulting party to close out open positions without the risk of "cherry-picking" by a trustee or other representative of the defaulting party's estate. He also discusses how regulatory authorities are recognizing the risk-reducing benefits of netting agreements for the purpose of measuring capital adequacy. Mr. Emert notes the importance of legislation upholding netting in cases of default or bankruptcy of a party to such a contract. He addresses issues arising from master agreements involving parties that trade in multiple jurisdictions—the "multibranch question." He provides an example of banks' trading in two jurisdictions to show the significance of netting. Mr. Emert concludes by addressing the risks of not knowing the identity of one's counterparty that can arise in dealing with financial intermediaries.

Ms. Ainslie analyzes the particular provisions of the International Foreign Exchange Master Agreement (IFEMA). She notes that a major issue is the extent to which enforceable global master agreements should protect against systemic risk by allowing the handling of a counterparty failure to be based on a net rather than on a gross valuation of the deals under the agreement. She discusses each of the general sections of IFEMA, explaining their significance and interrelationship. Ms. Ainslie notes that any product-specific master agreements can be combined with other product-specific master agreements by the use of an inclusive "master" master agreement.

Mr. Cunningham describes over-the-counter (OTC) derivatives, their uses, and the credit risk management technique for OTC derivatives known as netting. He explains that, although the label "OTC derivatives" encompasses a wide variety of instruments, an OTC derivative in essence is a nonstandardized financial instrument that does not trade through any particular exchange or clearinghouse. He addresses the benefits and risks of OTC derivatives transactions, including certain concerns of regulators: leverage and credit risk. He focuses on the International Swaps and Derivatives Association (ISDA) Master Agreement. Mr. Cunningham considers why netting works under the ISDA Master Agreement. In this area, he refers to the work of the Group of Thirty, the Basle Committee on Banking Supervision, and various governments. He notes that, in the countries represented on the Basle Committee on Banking Supervision, netting is generally the law. In certain jurisdictions that needed clarification, validating statutes have been enacted. In others, legal opinions provide the basis for their acceptance.

Mr. Raisler focuses on the risks of derivatives. He lists seven risks that are associated with derivatives: legal risk, credit risk, market risk, liquidity risk, operational risk, reputation risk, and systemic risk. He points out that an important finding of a Group of Thirty report on derivatives is that the risks of derivatives are fundamentally no different from the types of risks associated with traditional instruments, including loans, securities, and deposits. He recommends that the senior management of any institution investing in derivatives set the standards by which that entity will engage in derivatives and manage the program that it will implement. Mr. Raisler analyzes each of the risks associated with derivatives. Finally, he addresses an additional risk that he describes as the potential for legislative or regulatory risk overreaction.

Mr. Welshimer considers the general concepts underlying securitizations, the factors that have influenced their growth and development, and the benefits and risks to financial institutions and other parties that participate in the securitization process. He defines this process as taking rel-

atively illiquid assets originated by financial institutions and repackaging them into securities that can be sold to capital market investors. The effect is a form of disintermediation that replaces traditional bank lending funded by deposits with funding of the same assets directly by the capital markets. In part, the motivation for securitization is the desire of banks to reduce assets (and the required capital related thereto), to manage risk and generate fee income. Mr. Welshimer describes various kinds of securitizations. He concludes that securitization has been a great success in the United States and foresees that developments in U.S. securitizations over the next few years will increase the efficiency of the transactions. He notes that markets elsewhere are developing rapidly.

Mr. Giovanoli begins by defining the term "netting" as an agreed offsetting of positions or obligations by trading partners or participants in a system. He notes that interest in netting schemes and arrangements has focused on payment systems and contractual commitments, mainly in connection with derivatives and foreign exchange transactions. He then provides a general overview of the legal issues raised in connection with netting. He describes the origin and scope of netting. Next, he points out the need for central banks to oversee payment systems, with a view to ensuring their smooth and efficient functioning, as well as their integrity and stability. He distinguishes between gross settlement systems and net settlement systems and explains netting of contractual commitments and netting of payments. Mr. Giovanoli considers the risks involved in payment systems and how those risks can be reduced. National legislation and international initiatives, including initiatives of the Basle Committee and the European Union, are reviewed. In conclusion, he emphasizes the need for international harmonization of legislation on netting and payment systems.

Mr. Cohen notes that the principal systemic risk preoccupying central banks is settlement risk in respect of large-value payments. Some observers have proposed that all large-value payments should be made on a real-time gross settlement basis. He discusses the problems associated with this solution, including the costs to the private banking system of collateralizing such a system in accordance with central bank requirements. He surmises that, notwithstanding the flaws of real-time gross settlement, the systemic concerns over settlement risk are so great that they are likely to prompt comprehensive real-time gross settlement unless settlement risk can otherwise be reduced to an acceptable level. Mr. Cohen then turns to the principal means to effect that reduction: legally binding netting on an international basis. He notes that the key question is whether it is possible to construct a netting scheme that is binding in all relevant jurisdictions. He believes that the only way to achieve the necessary level of certainty is a legislative solution on an international level,

perhaps involving a model law to be enacted by participating countries by way of a treaty. He states that the U.S. experience illustrates the need for uniform, multijurisdictional legislation. He describes U.S. legislation that was needed to provide legal certainty with respect to netting.

Mr. Cohen addresses several legal issues arising in the context of legislated validation of netting arrangements: the scope of the netting legislation in terms of the institutions covered; bilateral versus multilateral netting; the obligations covered; the use of one or more currencies; obligations of different maturities; the degree of flexibility accorded to the central bank in administering netting legislation; the degree of specificity of the structural requirements for valid netting; conflict of laws; and the question of whether a netting contract should apply just to the local branch of an international bank operating outside its home country or to the entire bank. Finally, Mr. Cohen makes two points. First, if there is legally binding netting, it should be treated as such for purposes of the Basle capital guidelines. Second, in any payment system, there must be legal finality of payment.

Mr. Patrikis examines the concept of delivery against payment with regard to securities transfers. He describes how securities transactions were completed in the past with physical delivery of the certificates and compares the book-entry systems of today. He analyzes several types of delivery against payment systems. Reference is made, among others, to the Fedwire Clearing House Interbank Payments System (CHIPS), the Participants Trust Company, and the Central Gilts Office. Mr. Patrikis refers to the function of the central bank in the payment system, noting the Federal Reserve's role through Fedwire in extending daylight overdraft credit in the context of a real-time gross settlement system that provides securities against payment for federal government securities.

Ms. Fisher reviews the work of the Group of Ten central banks in the area of securities transfers. She points out that almost all securities transactions occur through intermediaries and that, as each intermediary is added to the process, new legal relationships are created that carry new risks. Another problem is that issuers and investors have no choice about the clearing and settlement mechanisms that are used. In addition, she notes that in a cross-border environment the issues that arise in the systems are compounded by questions of choice and conflict of laws. She explains the difficulties that investors face in trying to protect themselves from risk when they do not know which intermediary is involved, where it is located, and what country may claim jurisdiction over the transaction. She notes that there are two different types of schemes into which book-entry securities may be fitted: the legal regime applicable to physical securities, and special schemes that explicitly recognize electronic

securities. Finally, Ms. Fisher refers to the complex issues that can arise from the insolvency of intermediaries on the international scene.

Mr. Lorne provides two illustrations of why securities clearance and settlement are of interest to central banks. First, he describes the decline of security prices on, and consequent temporary closure of, the Hong Kong stock exchange in October 1987 and the "rescue package" that was put together by the authorities, the banks, and the brokers to reopen the exchange by lending to the guarantee corporations. Second, he reviews the circumstances surrounding the bankruptcy of the Drexel Burnham Lambert Group in New York in February 1990, which did not encompass that firm's broker-dealer or government securities subsidiaries. He explains how these examples illustrate the importance of the legal and practical aspects of securities clearance and settlement. Then, he asks what can be done to reduce the risks involved in the securities clearance and settlement system. He focuses on three approaches: shortening the settlement cycle, demobilizing or dematerializing securities, and creating and improving netting systems. Mr. Lorne states in conclusion that securities regulators and central bankers must work together to address the issues involved in improving the clearance and settlement system.

Mr. Houpt examines the emerging international capital standards, particularly standards for market risks arising from the trading activities of banks. He reviews two risk-measurement techniques considered by the Basle Committee on Banking Supervision: one based on a so-called standard approach that applies risk weights to various trading positions, and another based on the results of a bank's own internal models. He describes the 1988 Basle Capital Accord, which addressed credit risk—the risk that a borrower will default on its obligation and not repay the bank. Mr. Houpt notes that it did not address other important risks that banks face. One important risk is that evolving market conditions, such as changing interest rates or changes in the prices of equity instruments that banks trade, may affect a bank's financial strength. He describes the work of a subgroup established by the Basle Committee to address these matters. He reviews proposals concerning the supervisory treatment of market risks and the supervisory recognition of netting for capital adequacy purposes. In conclusion, Mr. Houpt offers some general observations on the process of developing such standards.

* * *

I would like to express my gratitude to Pamela Bickford Sak of the Legal Department and Thomas Walter of the Fund's External Relations Department for expert editorial assistance, and to Jai Oh of the Legal Department and to Jennifer Johnson, research assistant, and Aradhana

Kumar and Michael VanHuysen, interns, who lent their efforts importantly to the publication of this volume. Thanks also go to Clare Huang, my assistant, who contributed both to the seminar and to the publication of its proceedings. Several members of the Fund's Graphics Section also made important contributions: Philip Torsani designed the cover, and Julio R. Prego and Victor Barcelona typeset the text. Additional assistance was provided by Renée LaDue Bergfalk, Miriam Camino-Wolosky, Thet Mon Mya, Michael P. Filippello, and Steven Williams. Finally, I am indebted to François Gianviti, General Counsel of the International Monetary Fund, as well as to Ian McDonald of the Fund's External Relations Department, and to members of the IMF Institute, who, through their guidance and support, made this project possible.

Robert C. Effros

December 1996

Chapter

1 Developments at the International Monetary Fund

1A. Some Specific Legal Features of the International Monetary Fund

FRANÇOIS P. GIANVITI

Introduction

The fiftieth anniversary of the United Nations Monetary and Financial Conference was marked in 1994. This conference led to the creation of the International Monetary Fund and the International Bank for Reconstruction and Development. It was held at Bretton Woods, New Hampshire from July 1 to 22, 1944, which explains why the Fund and the Bank are often referred to as the Bretton Woods institutions.

The Articles of Agreement of the Fund and the Bank preceded the adoption of the charter of the United Nations, which was signed almost one year later, on June 26, 1945, in San Francisco, but the ratification process for the UN Charter was faster: the UN Charter came into force on October 24, 1945, whereas the Articles of the Fund and the Bank entered into force only on December 27, 1945.

Half a century has passed. The world has changed, and so has the Fund. The Bretton Woods Conference was attended by the delegations of 44 nations, some of which were still occupied by the enemy. As of July 6, 1994, the Fund had 179 members. In the meantime, the Articles of the Fund have been amended three times: in 1969, to introduce the Special Drawing Rights (SDR) mechanism; in 1978, to legalize the floating of exchange rates; and in 1992, to strengthen the Fund's sanctions against delinquent members.

As an international organization, the Fund presents a number of original features that distinguish it from most other organizations, including, although to a lesser extent, other financial organizations. It is a well-known fact that international organizations are initially created for specific purposes but gradually tend to expand their activities so that they eventually overlap with those of other organizations. A consequence of this trend is that it becomes increasingly difficult to define an organization's mandate and to tell what distinguishes it from others. Eventually,

the time may come when all international organizations become fungible because they all work for the greater good of mankind.

For the time being, however, there are differences among organizations. Some of these differences can be attributed to their charters, while others are the result of practice. As illustrations, two examples relating to the Fund can be mentioned (not as an exhaustive list, but as illustrations). The first example is the Fund's financial assistance to its members. The second example is state succession in the Fund.

Fund's Financial Assistance to Its Members

The Fund's financial assistance to its members is subject to different rules, depending on the origin of the resources involved.

In the General Resources Account (GRA), the Fund holds the currencies, gold, and SDRs contributed by its members in amounts equal to their quotas, plus all the accumulated reserves. These are the general resources of the Fund; they are available to all members.

In the Special Disbursement Account (SDA), the Fund holds the proceeds of the capital gains that it has made on sales of its gold, that is, the surplus over SDR 35 per ounce. These resources have been made available to developing countries with the lowest per capita incomes.

In Administered Accounts, the Fund holds resources contributed by members for specified purposes.[1] The Fund, in the management and disposition of these resources, may act as agent of the contributors or as trustee, depending on the terms of the instrument establishing the account.

Given the greater importance of the GRA in the Fund's financial assistance and the fact that most of the principles governing the GRA apply to the SDA, the following remarks will be limited to assistance from the GRA.

These remarks can be organized around three themes, which will show the specificity of the Fund as a financial institution:

- the purpose of the Fund's financial assistance;
- the technique of such assistance; and
- the conditions.

In these three respects, the specific features of the Fund's assistance reflect the monetary character of the organization, although, over the

years, this character has somewhat changed, and the specificity of the Fund's assistance has diminished.

Purpose

The purpose of the Fund's financial assistance is set out in the language of Article I(v) of the Fund's Articles:

> To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.[2]

In plain language, this means that the Fund is prepared to provide foreign exchange to its members for their external deficits if they are willing to correct the source of the problem through measures acceptable to the Fund. Therefore, the purpose of the Fund's assistance has two aspects: it helps the members solve their balance of payments problems, while avoiding their having to take recourse to harmful measures.

1. The reference to "balance of payments problems" is a key element in the definition of the purpose of the Fund's assistance, because it determines also the measure of the Fund's assistance. In other words, it is only to the extent that the member has an external financing problem that the Fund's assistance will be available. The purpose of the Fund's assistance also explains why the assistance is provided in foreign exchange rather than in the member's own currency. For instance, a member cannot request Fund assistance to have its budget deficit or credit expansion financed by the Fund, for either would be a misuse of the Fund's resources. To achieve either of these objectives, the member does not need foreign exchange: it can levy taxes or borrow the necessary amounts of its own currency. However, a budget deficit may also reflect net liabilities to foreign creditors as a consequence of an external imbalance, and credit expansion may be linked to import payments; accordingly, to that extent, the Fund's assistance will be available.

The concept of "balance of payments problem" might be understood as implying that, each time the Fund provides resources to a member, these resources must be earmarked for a particular payment. This may have been the intention of the founders of the Fund, as, in the original Articles, a member requesting assistance had to represent that it needed a particular currency, which it wished to obtain from the Fund, in order to make payments in that currency that were consistent with the Articles of Agreement.[3] In particular, a member was not allowed to use the Fund's resources in order "to meet a large or sustained outflow of

capital."[4] While the condition of need of a particular currency has now disappeared, together with the reference to particular payments, the limitation in Article VI, Section 1 has survived all the successive amendments of the Articles because it reflects a purpose of the Fund, which is "to facilitate the expansion and balanced growth of international trade. . . ."[5] Under the Articles, members are not allowed to impose restrictions on the making of payments and transfers for current international transactions,[6] that is, payments for goods and services, but they are allowed to restrict capital movements and may even be requested by the Fund to impose such restrictions.[7] Therefore, the limitation on the use of Fund resources parallels the member's rights and obligations with respect to exchange restrictions.

The idea of earmarked resources also explains various decisions taken during the initial years of the Fund. For instance, the Articles of Agreement were interpreted as precluding the use of Fund resources for the purchase of military equipment, which implies that resources obtained from the Fund could be traced.

Over the years, however, the fungibility of foreign exchange reserves has been recognized. For instance, instead of directly requesting assistance from the Fund for making certain payments in foreign currencies, a member may decide first to use its reserves in order to discharge its financial obligations and then to turn to the Fund in order to replenish its reserves. Similarly, the need to identify a particular currency gradually lost its justification as more currencies became convertible and could be used as international means of payment and stores of value. The fungibility of major currencies also allowed the Fund to expand its stock of usable currencies beyond the U.S. dollar, which was initially the only currency in demand.

This evolution led to a broader definition of the purpose of the Fund's assistance at the time of the Second Amendment. Although the concept of balance of payments problem still appears in Article I and is still widely used in Fund documents, the Articles now identify three possible purposes for Fund assistance. Under Article V, Section 3(*b*)(ii), the member must represent "that it has a need to make the purchase because of its balance of payments or its reserve position or developments in its reserves. . . ." It is clear from this provision that the specification of a particular currency by the requesting member has disappeared; the Fund has a stock of usable currencies that are available for financial assistance. More important, however, is the identification of three different types of "need." In particular, a deterioration in a member's "reserve position" may by itself justify the Fund's assistance, even if there is no balance of payments deficit. For instance, a country with a balance of payments sur-

plus would meet the condition of need if the level of its gross reserves fell too low because of some external payments. Even changes in the composition of reserves that are totally unrelated to balance of payments problems may give rise to Fund assistance.

In practice, however, as noted above, the traditional reference to a "balance of payments problem" as the criterion of Fund assistance has survived.

2. The second consideration that must guide the Fund in providing financial assistance is the avoidance of "measures destructive of national or international prosperity."[8] This is understood to mean avoiding exchange restrictions on current international transactions and also trade restrictions, to which the member might be tempted to resort when faced with a shortage of foreign exchange. More recently, concerns have been expressed about recourse to measures that may have an adverse effect on the environment or on the health or welfare of the population.

Technique

The Fund's assistance in the GRA is not provided in the form of loans but rather in the form of exchanges between the requesting member's currency and an equivalent amount of either another member's currency or SDRs. The balance acquired by the Fund in the requesting member's currency takes the form of an entry to the credit of the Fund in the books of that member's central bank (the issuer of the currency), unless the member prefers to substitute a nonnegotiable, non-interest-bearing promissory note payable to the Fund.[9] These swaps, which are called "purchases" by the Articles, are often referred to as "drawings" in Fund parlance. The terms "lending" and "loans," although technically incorrect, are also sometimes used because they are more easily understood by nonspecialists.

It may be noted in passing that, in the SDA and in Administered Accounts, loans in the true sense of the word are used to provide resources to members. The difference of loans from purchases is that in the former the borrowing member does not provide an equivalent amount of its currency.

Why are there purchases rather than loans in the GRA? The justification may have been that swaps are a well-known technique of support between central banks. These swaps between central banks are reversible, but, in the meantime, the borrower's currency is held as a form of collateral that may eventually be spent or sold if the swap is not reversed. Similarly, in respect of a purchase, the Fund would have the power to spend or sell its holdings of the member's currency. In practice, a sale

would take place only if, by the due date, the transaction were not reversed; until then, the Fund would refrain from selling that currency to avoid a drain on the member's reserves. A sale by the Fund can be made only to another member, unless the issuer of the currency ceases itself to be a member of the Fund, in which case a sale in the market becomes possible. Despite the apparent guarantee provided by this technique, it would be extremely difficult for the Fund to dispose of the currency of a member in default, because that currency would have depreciated and might not be accepted by any purchaser except at a heavy discount. Moreover, the Fund's holdings are not held in notes and coins. These holdings may be reflected in a balance in the Fund's account with the debtor's central bank, in which case the transfer of the Fund's holdings needs to be recorded by that central bank. Alternatively, they may be represented by a promissory note, in which case, when encashment is requested, the debtor has to be able and willing to provide the required amount of its currency. The system is built on confidence and assumes that good faith will prevail.

Depreciation of the issuer's currency is one of the risks of this type of transaction. The drafters of the Articles were aware of this risk. They imposed on all members an obligation to maintain the value of the Fund's holdings of their currencies in the GRA;[10] the value must be maintained in terms of the SDR, which is the unit of account of the GRA.

Conditions

Each new member of the Fund is offered a quota, which must be fully paid in the media specified by the Fund. Typically, a new member would pay 75 percent of its quota in its own currency (for example, by crediting the Fund's account with the member's central bank or by issuing a promissory note) and 25 percent in SDRs or another member's currency as specified by the Fund. (Formerly, that portion was paid in gold but with some limitations.) Quotas are periodically reviewed and may be increased with the payment of additional amounts, but no change can take place without the consent of the member concerned.

The member's net contribution to the Fund is equivalent to the amount paid in SDRs or foreign currencies, which is usually 25 percent of quota. An equivalent amount can be drawn on the Fund by the member at any time, without cost or conditions other than the substitution of the member's own currency;[11] there is no obligation to repurchase the amount drawn. Because the net contribution used to correspond to each member's gold payment to the Fund, the equivalent available amount used to be called the gold tranche; it is now known as the reserve tranche. Drawings

in the reserve tranche are a form of use of the Fund's resources,[12] but they are not regarded as part of the Fund's financial assistance.

Once the reserve tranche has been fully drawn and replaced with the purchasing member's currency, the Fund's holdings of the member's currency stand at 100 percent of quota. Beyond that, the member is using the Fund's financial assistance, and the use of the Fund's general resources will continue as long as the Fund's holdings of the member's currency are not reduced to 100 percent or below.

Above 100 percent of quota, the Fund's conditions for the use of its general resources gradually tighten, and these conditions may also vary with the type of problem faced by the member. Different policies have been adopted by the Fund to assist members facing different types of balance of payments problems. These policies will not be discussed here, but some general principles will be mentioned.

First, between 100 percent and 200 percent of quota, a member is "entitled" to use the Fund's resources. Under the original Articles of Agreement, it was not clear whether the Fund could impose certain conditions on the exercise of this entitlement. Countries had different interpretations of the Articles on this point. The United States, which was the main provider of usable resources to the Fund, was firmly of the view that the Fund could deny a request for assistance if it found that the member's adjustment policies were inadequate. The U.S. position prevailed. As early as March 1948, this interpretation was adopted by the Fund.[13] The result was that the financial activities of the Fund almost came to a halt because the main potential users of Fund resources did not wish to face a possible challenge to their requests, which would have been perceived as a public affront to their governments and criticism of their policies.

The 1948 interpretation was a success for those that wanted to limit the use of Fund resources, but that success soon became a source of concern for the organization, which had to find some means of restoring access to its resources. The obvious remedy was to create an entitlement that would not be subject to challenge. That is how stand-by arrangements (initially stand-by agreements) were invented. Beginning in 1952, decisions assuring members that they could purchase a certain amount of foreign exchange over the next six months were adopted. The policy was formalized in 1953, with, as its key element, the concept of a right not subject to review by the Fund, that is, a right that cannot be challenged when exercised by the member.

Stand-by arrangements were supposed to be for six-month periods. However, the pendulum later started moving in the other direction, and arrangements were granted for longer periods. The exercise of the

member's right gradually became subject to various conditions that were objectively defined (performance criteria) and to periodic reviews by the Fund for the setting of subsequent conditions.

Since the Second Amendment of the Articles, a stand-by or other arrangement (which may include an "extended arrangement" of longer duration) is defined by the Articles as "a decision of the Fund by which a member is assured that it will be able to make purchases from the GRA in accordance with the terms of the decision during a specified period and up to a specified amount."[14]

This definition is interesting in two respects. First, it confirms the traditional legal position of the Fund on the nature of Fund arrangements: they are not contracts between members and the Fund, but unilateral decisions of the Fund. Second, the definition recognizes that the member's right to make purchases under the arrangement is subject to the terms of the arrangement, which means that conditions can be imposed, such as performance criteria and reviews. However, conditions are not obligations. If the member fails to meet the conditions under the arrangement, its right to make purchases is suspended, but there is no breach of an international or other obligation to the Fund.

Despite this provision, the legal nature of Fund arrangements remains controversial. Some writers have taken the view that, as a Fund arrangement is approved at the request of a member, the request is an offer by the member and the Fund's decision an acceptance, which, taken together, constitute a contract. Given the unambiguous language of Article XXX, the discussion is purely academic. The underlying logic of Article XXX can be explained as follows. Although the entitlement conferred by the Articles to use the Fund's general resources has been weakened by the 1948 interpretation, which has now been incorporated into the new Article V, Section 3(*c*), the entitlement still exists.[15] The Fund cannot deny a request for a purchase if the member meets the required conditions. Therefore, the approval of an arrangement is not an exercise by the Fund of a discretionary power, but the recognition of the member's entitlement to use the Fund's general resources.

Second, when the Fund's holdings of the member's currency reach 200 percent of quota, the entitlement ceases, and, for any additional assistance, a waiver must be obtained from the Fund. As a condition of the waiver, the Fund has the authority to require collateral or the acceptance of particular obligations, such as a shorter repurchase period. In practice, such conditions have not been imposed.

Third, whether the Fund authorizes a purchase or approves an arrangement, the use of its resources is subject to conditions that are themselves

related to the purpose of the assistance, namely, to solve the member's balance of payments problems without resorting to measures destructive of national or international prosperity. However, the conditions are also intended to safeguard the Fund's resources. The Fund's conditionality is defined by the policies of the Fund adopted in accordance with Article V, Section 3(*a*):

> The Fund shall adopt policies on the use of its general resources, including policies on stand-by or similar arrangements, and may adopt special policies for special balance of payments problems, that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund.

In the practice of the Fund, it is understood that conditionality must be uniform for all members. When access limits are specified for a particular policy, it must be expressed uniformly for all members in terms of quotas. Obviously, given the diversity in individual circumstances of members, individual conditions for the use of Fund resources may vary, but within a common framework. Different policies can also be implemented for different types of problems, but not for different countries or lists of countries. For instance, in the GRA, no distinction is made between developing and developed countries. In 1993, the Systemic Transformation Facility was created for countries facing an acute balance of payments problem due to the transition in their international trade from nonmarket prices to market pricing, but any country facing that problem could receive the financial assistance of the Fund within the prescribed limits and conditions.[16]

Conditionality must be geared strictly to its purpose. There is no room for political conditions or any other irrelevant considerations, tempting as it may be to use the Fund's resources for such purposes.

In conclusion, the Fund's financial assistance from the GRA is specific in its purpose, technique, and conditions. However, the law of entropy applies to international organizations. As time passes, the initial purposes are forgotten or seem no longer relevant, and specific features tend to be eroded. Purchases from the Fund are often called loans, which trivializes their nature, and many seem to believe that these so-called loans should be disbursed for the same purposes as those of a development institution. The principle of uniform treatment of members is seen by some as a relic of the past that should be replaced with a distinction between developing and developed countries, with only the former being given financial support. Pressure is applied to bend general policies toward case-by-case decisions where political considerations can play a decisive role. Nongovernmental organizations urge governments to expand the Fund's

conditionality to achieve their own agenda. Intergovernmental organizations that have no financial resources would like to make the Fund the instrument of their own policies.

Fifty years after its creation, the Fund has reached a crossroads. Evolution has taken place and will continue. The question is how far this evolution can go before the Fund loses its specificity as a monetary institution and thus its raison d'être.

State Succession in the Fund

State succession is one of those difficult problems of international law that have not yet found universally accepted solutions. Two conventions have been prepared by the International Law Commission, but they have not entered into force, essentially because of remaining disagreements on some of their provisions.[17]

In the history of the Fund, there have been several cases of changes in the legal status of members. Sometimes a member has absorbed a nonmember: the German Democratic Republic, which was a nonmember, acceded to the Federal Republic of Germany, a member, in 1990. Slightly different but similar in its effects is the merger between a nonmember and a member: Tanganyika (a member) and Zanzibar (a nonmember) merged in 1964. In both cases the result was an expansion of a member's territory, without any effect on membership in the Fund.

A third type of case is the merger of two Fund members: in 1958, Egypt and Syria merged to create the United Arab Republic, and, in 1990, the two Yemens merged to become the Republic of Yemen. In both instances, the Fund's membership was reduced by one unit, but there was no membership procedure as for the admission of a new member. There was no resolution of the Board of Governors and no calculation of a new quota. The Executive Board took note of the merger, and the quotas of the former members were amalgamated to form the single quota of the new country. In a sense, it was a continuation of membership under a single name instead of two. The only practical consequence of a merger is that, as each member is allotted 250 basic votes, the total of 500 basic votes for the two members before the merger is reduced to 250 after the merger.

More difficult are the problems raised when territories within a member state become independent. There are two possible situations.

The first one is secession. For instance, Pakistan seceded from India in 1947, Singapore from Malaysia in 1965, Bangladesh from Pakistan in 1972, and Eritrea from Ethiopia in 1993. In addition, numerous former

colonies have become independent over the years. In each case of secession, the international community has recognized that the seceding territory's accession to independence does not affect the continued existence of the country from which it has seceded. Consequently, that country does not lose its membership in international organizations. More specifically, in the Fund, that country will retain its quota, as well as all its assets and liabilities; the Fund could not impose a reduction in quota on a member, even when its territory has been reduced. Conversely, the newly independent country does not automatically become a member of the Fund. In order to be admitted to membership, it must make an application that will be examined by the Fund. If the conditions for membership are met, a membership offer with a specified quota, as calculated by the Fund, will be made by the Board of Governors. The procedure will be completed when the new member signs the Articles of Agreement, thus accepting the obligations attached to membership under the Articles.

The other situation, less common but more difficult, is the dissolution of a member. For instance, in 1961, after three years of existence, the United Arab Republic was dissolved; Egypt and Syria regained their respective independence. It was undisputed that there was no secession of one or the other from the United Arab Republic but a disintegration of the United Arab Republic into two successor states. The Fund, as well as the United Nations, took the view that there was no need to go through an admission procedure for Egypt and Syria. They were recognized by the Executive Board as separate members of the Fund, and their former respective quotas were reinstated. Fortunately, there had been no change in the quota of the United Arab Republic during the interim period. Otherwise, the reallocation of that quota between the two countries could have been problematic.

The dissolution of the United Arab Republic could be handled in a pragmatic fashion because that entity was itself the recent product of the merger of two Fund members. In 1992, however, two much more difficult cases had to be faced by the Fund: the dissolution of the Socialist Federal Republic of Yugoslavia and the dissolution of Czechoslovakia. The two cases were similar in most respects, except for three major differences. The first one was that two of the six federal republics that constituted the Socialist Federal Republic of Yugoslavia (Serbia and Montenegro) were of the view that the Federation had not been dissolved[18] and that the independence proclaimed by the other four republics should be considered as a case of secession from, not of dissolution of, the Socialist Federal Republic of Yugoslavia. The second difference was that war had erupted in the territories of the Socialist Federal Republic; the Federal Republic of Yugoslavia (Serbia and Montenegro)

was subject to sanctions imposed by the Security Council of the United Nations, and the territory of the Republic of Bosnia and Herzegovina was not fully under the control of its government. The third difference was that, among the six former republics of the Socialist Federal Republic of Yugoslavia, the Republic of Macedonia was not recognized by many countries for various reasons, one of which being its name, which was found unacceptable and even offensive by its neighbor, Greece.[19] The international status of the Socialist Federal Republic of Yugoslavia was further complicated by the inability of the United Nations to reach a conclusion as to its continuation or dissolution: the Security Council recommended a finding of dissolution, but the General Assembly preferred to suspend the exercise of Yugoslavia's rights in the UN without terminating its membership.[20]

In the Fund, a finding of continuation of Yugoslavia would have meant that the four "seceding" republics (Slovenia, Croatia, Bosnia and Herzegovina, and Macedonia) would have had to be admitted with quotas additional to that of the Socialist Federal Republic of Yugoslavia, which would have remained the same, although for a much smaller country (Serbia and Montenegro). Moreover, there was a general feeling that the new Federal Republic of Yugoslavia could not be regarded as a continuation of the old Federation, as that had disintegrated. The Arbitration Committee of the Conference on Yugoslavia (chaired by Mr. Robert Badinter) had reached the same conclusion.[21] Therefore, dissolution, rather than secession, was the more obvious conclusion.

If dissolution it was, who were the successors? On what basis would the assets and liabilities of the Socialist Federal Republic be allocated among them? Once an allocation had been calculated, could a successor object to its share, and how would the dispute be settled? Would all the successors be jointly and severally liable to the Fund for the debt of the Federation?

Assuming that these difficulties were overcome, how would a successor become a Fund member? Under what procedure: admission pursuant to a resolution of the Board of Governors, or otherwise? Could there be a succession to membership as there was a succession to assets and liabilities? Would the successors be allowed to become members individually, or would there be a collective succession to membership? In the latter case, failure by one of the successors to meet the conditions for membership or its unwillingness to become a member could prevent the others from succeeding to membership; individual admission would be their only recourse.

In the absence of any explicit provision in the Articles on state succession, all these questions required innovative answers. Precedents were

also relevant, which showed a willingness on the part of the Fund to find pragmatic solutions, preferably with the consent of all the parties concerned. Moreover, the specific features of the Fund could not be ignored. If the successors to the Socialist Federal Republic joined the Fund as new members, the accounts of the old member would have to be liquidated. In the SDR Department, the SDRs allocated to the Socialist Federal Republic would have to be canceled, thus creating an additional liability for the successors, which would have to return an equivalent amount to the SDR Department. In the General Department, the successors would lose the benefit of any capital gain on the gold subscription of the Socialist Federal Republic as this capital gain can belong only to members that joined the Fund before September 1, 1975. These adverse consequences could be avoided only if the successors were deemed to continue, each for its share, the membership of the Socialist Federal Republic of Yugoslavia in the Fund. Admission to membership as new members would not achieve that objective, while succession to membership would. Another advantage of succession was that it did not require a resolution of the Board of Governors: the Executive Board could take all necessary decisions.

An analysis of the different aspects of the problem showed that two stages had to be identified. First, regardless of the position taken on membership, the succession to assets and liabilities had to be determined. Then, once the allocation had been made, admission or succession to membership could be envisaged, with succession as the preferred approach, given the disadvantages of admission.

However, the two stages had two common elements. First, both the allocation and the membership decisions had to be based on a quantitative criterion, namely, the notional share of each successor in the quota, assets, and liabilities of its predecessor in the Fund. Second, the number of successors had to be decided. Clearly, Slovenia, Croatia, Bosnia and Herzegovina, and the Federal Republic of Yugoslavia (Serbia and Montenegro) were recognized by the international community. The existence of Macedonia as an independent country was undisputed, but it was not officially recognized. Ignoring its existence would have led to a division of the quota, assets, and liabilities of the Socialist Federal Republic among four successors, thus leaving out Macedonia—a totally unrealistic solution. Therefore, it was concluded that Macedonia should be included in the calculation, but with a provisional designation as "the former Yugoslav Republic of Macedonia" until a name was agreed upon between that country and the Fund.

In spite, or perhaps because, of their complexity, the problems of state succession in Yugoslavia gave the Fund the opportunity to clarify its

position on a number of issues of principle. These conclusions can be summarized as follows:

- It is for the Fund to determine, for its own purposes, whether a member has ceased to exist and, therefore, has ceased to be a member of the Fund. The Fund, when making this finding, is not bound by the position taken (or absence thereof) by other organizations, including the United Nations.

- If a finding of dissolution is made, it is for the Fund to identify the successor states. The fact that a successor state is not generally recognized by the international community does not preclude the Fund from finding this state to be a successor to the former member if its existence as an independent state is in fact acknowledged.

- The former member's assets and liabilities in the Fund are allocated by the Fund among the successor states on the basis of calculated "notional quotas." Each successor state may either accept its share in assets and liabilities as calculated by the Fund or challenge it before an arbitral tribunal. The successor states are not jointly and severally liable for the debts of their predecessor to the Fund.

- Any successor state that has accepted its share in assets and liabilities as calculated by the Fund (or as amended by arbitration) may succeed to its predecessor's membership in the Fund, within the period specified by the Fund, if it has been found by the Fund to be able to meet its obligations under the Articles of Agreement and has no arrears to the Fund or in the SDR Department. The successor's quota will be equal to the notional quota that was used to allocate assets and liabilities.

- A successor state that succeeds to its predecessor's membership will be deemed to continue that membership in the Fund. To that extent, there will be no liquidation of the predecessor's accounts with the Fund. In particular, the SDRs allocated to the predecessor will not be canceled, and, in case of liquidation of the Fund, any outstanding capital gain on the predecessor's gold subscription will be paid to the successor if the predecessor joined the Fund before September 1, 1975 (which was the case for Yugoslavia, but not for Czechoslovakia).

On the basis of these principles, the Fund, on December 14, 1992, found that the Socialist Federal Republic of Yugoslavia had ceased to exist, determined the respective shares of the five successors in the assets and liabilities of the Socialist Federal Republic in the Fund, and made an offer of membership to all of them subject to the conditions mentioned above.

Recourse to "individual offers of membership," rather than a declaration of joint successions to membership (as in the case of the dissolution of the United Arab Republic), was made necessary by the circumstances of Yugoslavia.[22] First, at the time of the finding of dissolution by the Fund, the Socialist Federal Republic of Yugoslavia was in arrears to the Fund, and it was not clear when each successor could discharge its share of these liabilities to the Fund. Probably, given their different circumstances, the membership process would not be completed at the same time for all of them. Second, the Fund had to take account of the war in Bosnia and Herzegovina and the international sanctions against the Federal Republic of Yugoslavia (Serbia and Montenegro), which were likely to delay the Fund's finding of ability to meet membership obligations.[23] It was not clear at the time of the decision when any of these countries would be able to meet their obligations under the Articles. For the more difficult cases, a radical approach would have been not to make them an offer, but this would have been discriminatory; alternatively, an offer subject to further confirmation by the Fund would not have been an offer at all. It may be noted that the conditions attached to the offer reflect the standard condition for all new members: the finding of ability to meet membership obligations is usually implicit but always precedes the adoption of the Board of Governors' resolution. The clearance of arrears is a partial demonstration of that ability.

Since the decision of December 14, 1992, Croatia, Slovenia, and the former Yugoslav Republic of Macedonia have become members of the Fund. The period initially prescribed for the completion of the membership procedure has been extended for the other two successors.

In the case of the dissolution of Czechoslovakia, the same basic principles were applied, except that simultaneous succession to membership of the two successor states could be arranged because the finding of ability to meet membership obligations did not raise any difficulty.[24] The Czech Republic and the Slovak Republic became members on January 1, 1993, thereby succeeding to the membership of Czechoslovakia in the Fund.

The successors of the Socialist Federal Republic of Yugoslavia in the Fund are now deemed to have been members of the Fund since December 27, 1945, and the successors of Czechoslovakia since September 20, 1990.

1B. The Relationship Between the International Monetary Fund and the United Nations

WILLIAM E. HOLDER

Introduction

It is timely to review the present relationship between the International Monetary Fund and the United Nations, for several reasons. First, the number of intergovernmental entities continues to increase, with, for example, the recent establishment of the World Trade Organization and the Global Environmental Facility; thus, issues arise concerning the additional level of interaction between the old and the new structures. Second, existing organizations grow in both functions and scope, evolving to respond to new circumstances and challenges. Accordingly, there arises the reality of overlapping functions between organizations. Not surprisingly, therefore, there are calls for rationalization of resources, the division of labor," and coordination of policies and activities. With the fiftieth anniversary of the drafting of the charters of the Fund and the World Bank (the Bretton Woods institutions), those calls are likely to increase, from official and unofficial sources. Finally, given the maturity of the Fund-UN relationship, it might be useful to restate the essence of the existing relationship and, in so doing, to seek to remedy some common misunderstandings.

Institutions

The United Nations and the Fund were created as international public organizations. Each has its own charter or constitutional document: in the case of the UN, the Charter of the United Nations; and in the case of the Fund, the Articles of Agreement. Each charter was negotiated separately; that is, the Fund terms were not negotiated as part of the United Nations, although the motivation for the creation of both was to bring postwar order to the world upon the cessation of World War II.

The Fund

The Fund is a creation of the Articles of Agreement and is controlled by the Articles. Accordingly, the Fund has specified purposes, functions, and powers. To these ends, it has its own resources, organs, and membership. Moreover, under the Articles, members enjoy a range of rights

and privileges, and, reciprocally, are subject to various obligations and powers.

The United Nations

As with the Articles of the Fund, the UN Charter was finalized toward the end of World War II. By this treaty, the "United Nations" laid down lofty goals, both in the preamble and Article 1. By its explicit purposes, the UN is "to maintain international peace and security," including through the taking of collective measures and the peaceful settlement of disputes; to develop friendly international relations; "to achieve international co-operation in solving international problems of an economic, social, cultural, or humanitarian character," together with respect for human rights; and to harmonize national action in these respects.[1]

Concept of "Specialized Agencies"

Both the UN and the Fund are subjects of international law, with explicitly conferred legal personality ("full juridical personality" in the case of the Fund, "such legal capacity as may be necessary" in the case of the UN).[2] Accordingly, each can enter into agreements with other subjects of international law.

Agreements *inter se*, however, are contemplated by the respective charters. First, by Article X of the Fund's Articles, the Fund is to cooperate "with any general international organization," as well as with public international organizations with related fields of specialized responsibilities. Two qualifications apply: first, such cooperation will be "within the terms of this Agreement"; second, were a modification of the terms of the Articles involved, the effectiveness must await an amendment of the Articles.[3] Clearly, reference to cooperation "with any general international organization" was in anticipation of the UN, although express reference could not be made because the UN Charter followed the drafting of the Fund's Articles.

In the case of the UN, it was contemplated that those specialized agencies having wide international responsibilities "shall be brought into relationship with the United Nations" pursuant to the provisions of Article 63.[4] In turn, Article 63 prescribes that the relevant organ for entering into such agreements shall be the Economic and Social Council (ECOSOC), "subject to approval by the General Assembly." Finally, Article 57, paragraph 2 states that "[s]uch agencies thus brought into relationship with the United Nations are hereinafter referred to as specialized agencies."

In the light of these provisions, a comment on the term "specialized agencies" may be in order. Article 57 begins factually by referring to existing (or future) specialized agencies. It follows that the entering into of a relationship agreement does not generate the status of a specialized agency; rather, that status is a prerequisite of entering into agreement. Moreover, this is the case notwithstanding that Article 57, paragraph 2, goes on to refer to specialized agencies as agencies that have entered into a relationship agreement. Finally, the negotiating record makes clear that, despite the acceptance of Article 57, paragraph 2, there was an express understanding that the relationship between the UN and the Fund was one of mutual association between independent entities.

More specifically, the Fund negotiators agreed to the statement that "[t]he Fund is a specialized agency established by agreement among its member governments. . . ."[5] This statement reflected the idea that, once the relationship agreement was concluded, the Fund would become a specialized agency within the meaning of the UN Charter. This wording, however, has to be read in the light of the following statement, which was placed on the record:

> It was understood . . . that the statement in Article I, paragraph 2, that the Bank (Fund) is a Specialized Agency established by agreement among its member governments carries with it no implication that the relationship between the United Nations and the Bank (Fund) is one of principal and agent.[6]

In conclusion, therefore, while the Fund is a specialized agency as referred to in the UN Charter, it is not a specialized "agency" (or agent) of the United Nations.

The Fund as an Independent Organization

The Agreement Between the United Nations and the International Monetary Fund (the Relationship Agreement), as well as the Agreement Between the United Nations and the International Bank for Reconstruction and Development, came into force on November 15, 1947 following a vigorous negotiation between the UN and, jointly, the Fund and the World Bank.[7] The two resulting Agreements are the same, except for an additional clause in the World Bank Agreement on loans (Article IV, paragraph 3; see below).[8]

Independence of the Fund

The negotiation of the Relationship Agreement had to bridge a considerable difference of orientation between the two sides. From the point

of view of the UN, even if the Fund and the World Bank were in a special position, the UN had the duty under its Charter to coordinate the actions of specialized agencies and had to follow the mandatory character of certain Charter provisions. On the side of the Fund and the World Bank, the independent character of the institutions, stemming from their basic documents, the terms and the conditions under which they were executed, and their responsibilities, were emphasized strongly. Moreover, influence on their decisions by political bodies could not be tolerated.

Within the day, the original draft provision regarding the relationship of the UN with the Fund, instead of being weakened, was strengthened somewhat. Article I, paragraph 2 of the Relationship Agreement, after reciting that the Fund is a specialized agency within the meaning of Article 57 of the Charter, asserts the independence of the Fund:

> By reason of the nature of its international responsibilities and the terms of its Articles of Agreement, the Fund is, and is required to function as, an independent international organization.

This provision manifests the independence of the Fund under its Articles, whereby certain functions are vested in its organs, and, therefore, that the competence conferred cannot be delegated to, or subject to, another organization or body external to the institution.

As previously mentioned, the UN-World Bank Agreement contains a clause on the loan process; this provision is also designed to protect the independence of the World Bank. Specifically, Article IV, paragraph 3 of the World Bank Agreement states:

> The United Nations recognizes that the action to be taken by the Bank on any loan is a matter to be determined by the independent exercise of the Bank's own judgment in accordance with the Bank's Articles of Agreement. The United Nations recognizes, therefore, that it would be sound policy to refrain from making recommendations to the Bank with respect to particular loans or with respect to terms and conditions of financing by the Bank. The Bank recognizes that the United Nations and its organs may appropriately make recommendations with respect to the technical aspects of reconstruction or development plans, programmes or projects.

Does the lack of such a clause indicate a different result for the Fund? In fact, the explanation lies in the aspect of the operation of the Fund: not only did the Fund not make loans, but the use of Fund resources was a matter of entitlement. Thus, the report of the Negotiating Committee states:

> It was further agreed that Article IV, paragraph 3, was omitted from the Agreement with the Fund only because the Fund does not make loans. It was agreed that the philosophy underlying this paragraph applied to the

relationship between the United Nations and the Fund as well as the relationship between the United Nations and the Bank.[9]

Case of South Africa

At times, this independence of the Fund has been put to the test, in particular, concerning the Fund's relations with South Africa. From 1964, the United Nations, primarily through the General Assembly, but at times by decision of the Security Council, adopted resolutions attacking apartheid in South Africa and requesting the specialized agencies to take appropriate supportive steps. Following the normal practice for the treatment of such resolutions, these resolutions, when received by the Fund, were distributed to Executive Directors, without further action, and with a brief acknowledgement to the UN. In so doing, Article IV, paragraph 2 of the Relationship Agreement played a part: thereby, each organization undertakes to consider as soon as possible any "formal recommendations," but only after "reasonable prior consultation with regard thereto." In fact, there had been no such prior consultation.

In 1981–82, however, in the context of possible use of Fund resources by South Africa, the dialogue became more intense. On December 17, 1981, the General Assembly expressed concern that the Fund (and the World Bank) had not taken steps to terminate assistance to South Africa, requested them to do so, and called for consultations with the Fund and the World Bank on the matter.[10] A further General Assembly resolution repeated the requests on October 21, 1982 in essentially the same terms.[11] Shortly thereafter, the Managing Director of the Fund met with a delegation from the United Nations Special Committee Against Apartheid. On November 3, 1982, the Executive Board of the Fund approved the use of Fund resources by South Africa, pursuant to a stand-by arrangement and under the Compensatory Financing Facility.[12]

In its deliberations and communications, the Fund took the approach that all organs of the Fund were required to adhere to the Articles of Agreement, and that, under the Articles, the rights of a member must be respected, including the member's entitlement to use Fund resources, in accordance with Fund policies on the use of Fund resources, subject to the final decision of the Executive Board. Moreover, the UN was reminded that these principles were reflected in the Relationship Agreement, in that the Fund is to act as an independent institution.

Situation of a Binding Security Council Resolution

In the event of a Security Council resolution, which by its terms binds members under Article 48 of the UN Charter, there is need for

elaboration.[13] In this contingency, the Relationship Agreement contains a specific provision. Article VI, paragraph 1, reads:

> 1. The Fund takes note of the obligation assumed, under paragraph 2 of Article 48 of the United Nations Charter, by such of its members as are also Members of the United Nations, to carry out the decisions of the Security Council through their action in the appropriate specialized agencies of which they are members, and will, in the conduct of its activities, have due regard for decisions of the Security Council under Articles 41 and 42 of the United Nations Charter.

This provision presents a quite different balance to that put forward by the UN initially, which would have imposed an obligation impacting more directly on the organization.[14]

Under this provision of the Relationship Agreement, a Security Council resolution would not be binding on the Fund itself. First, the binding obligation stemming from a Security Council resolution is directed at "members" of the UN. The Fund, while a subject of international law, is not a member; meanwhile, most decisions of the Fund are taken by the Fund's competent organs, not by its members. Second, the obligation of the Fund, in turn, is to "have due regard" to Security Council resolutions. Such an obligation could be respected by the Fund's competent organs while still taking independent action. Finally, there is the question of whether, with the obligation of Security Council resolutions falling on members of the UN, those members who are also members of the Fund must instruct Executive Directors appointed or elected by them to take appropriate action at the Executive Board. In the view of the Fund, however, under the Articles of the Fund, the Executive Directors serve as "officials" of the Fund, not as "representatives" of the members appointing or electing them. Thus, an Executive Director would not be under an obligation to carry out the obligations of members that are also members of the UN. On the contrary, the Executive Director would, as an official of the Fund, have to act in the Fund's interests, including the adherence to its Articles and the protection of the Fund's assets.

As a result, the competent organs of the Fund are in a position to act independently under the provisions of the Articles and other policies of the Fund. Thus, in the case of embargoes and the freezing of assets that are imposed by the UN on its members, the consistency of the action of a Fund member with the Articles is still to be assessed, on the Fund's side, by the Fund standards. In the same way, the Fund itself is entitled to engage in financial transactions with a member that is the object of the UN embargo and, in particular, to recover amounts due from the member (if, indeed, national law does not prevent it).

Budget

Another element of the Fund's independence might be mentioned: UN competence to review the Fund's budget. Under Article 17, paragraph 3, of the UN Charter,

> 3. The General Assembly shall consider and approve any financial and budgetary arrangements with specialized agencies referred to in Article 57 and shall examine the administrative budgets of such specialized agencies with a view to making recommendations to the agencies concerned.

For the specialized agencies other than the Fund and the Bank, the relationship agreements reflect this mandate; their budgets are thus submitted to the UN for General Assembly examination and recommendation.[15]

Yet the UN does not "consider and approve" the Fund's budget. Again, the Relationship Agreement addressed the point. Article X, paragraph 3, second sentence, states:

> The United Nations agrees that, in the interpretation of paragraph 3 of Article 17 of the United Nations Charter it will take into consideration that the Fund does not rely for its annual budget upon contributions from its members, and that the appropriate authorities of the Fund enjoy full autonomy in deciding the form and content of such budget.

This provision thus exempts the Fund from the general supervision of Article 17, paragraph 3, of the UN Charter. During the negotiation of the clause, it was accepted that, as the Fund and the Bank do not rely on the contributions of its members for their financing, the General Assembly lacked a rationale for its normal involvement. Furthermore, while the Relationship Agreement posits that the Fund's Annual Report and quarterly financial statements are to be furnished to the UN,[16] the understanding remained that no recommendations were to be made by the UN.

Cooperation

While admitting that the relationship of the UN and the Fund is one between separate, independent organizations, the Relationship Agreement posits a wide variety of points of interaction and mutual cooperation.

Reciprocal Representation (Article II). The UN is entitled to attend the meetings of the Fund's Board of Governors. As for the Executive Board, the UN is to be invited to attend "meetings especially called by the Fund for the particular purpose of considering the United Nations point of view in matters of concern to the United Nations."[17] Conversely, the

Fund shall be entitled to attend the General Assembly, ECOSOC, and the Trusteeship Council.

Agenda Items (Article III). The Agreement envisages consideration for inclusion of agenda items, on the one hand, for the meetings of the Fund's Board of Governors, and, on the other hand, for ECOSOC and its commissions.

Consultations and Recommendations (Article IV). Under Article IV, paragraph 1, "[t]he United Nations and the Fund shall consult together and exchange views on matters of mutual interest." As a qualification, however, it is provided that one of the organizations shall not present "formal recommendations" to the other "without reasonable consultation with regard thereto."[18]

Exchange of Information (Article V). The Agreement calls for the exchange of information "to the fullest extent practicable," including publications, special reports, and studies. To this exchange, an important qualification is attached: it is accepted that confidential information furnished by respective members is to be respected.[19]

Statistical Services (Article IX). While the special interests of each organization are accepted, the organizations are to cooperate for common purposes and to avoid duplication.

Administrative Relationships (Article X). Specifically, the UN and the Fund are to consult periodically "concerning personnel and administrative matters of mutual interest," toward the end of uniformity and efficiency. Consistently, the Fund agrees to participate in the work of the Coordination Committee and its subsidiary bodies.

Conclusion

The relationship between the Fund and the UN has been controlled by the Relationship Agreement for close to 50 years. It has survived intact during that time. By its terms, the purposes of the Agreement may be subject to supplementary agreements.[20] The Relationship Agreement also contemplates the possibility of revision.[21] Alternatively, it may be terminated by either side upon six months' written notice.[22]

The resulting relationship, however, has attracted considerable criticism (as evidenced, for example, in the South African saga). In the nominal coordination with the UN, some see a contradiction in the light of the assertion of independence of the Fund, both in theory and practice. Others accept the present situation, but call for reform.

In recent years, the topic has been quite active, especially in connection with the review of the structure of the UN itself, focusing on the economic area. In particular, the General Assembly called for reforms so that ECOSOC can

> discharge the responsibilities entrusted to it by the Charter by enhancing its role as a central forum for major economic, social and related issues and policies and its co-ordinating functions relating to the United Nations system in the economic, social and related fields.[23]

Since then, work has continued and ideas have proliferated.

In 1993, at the request of the Secretary-General, a special report was issued to the Administrative Committee on Coordination (ACC) by a consultant, Mr. Francis Blanchard (former Director-General of the International Labor Organization).[24] The report covers considerable ground concerning the relationship of the Fund (and the World Bank) and the UN. In essence, even though the ACC was set up to deal with administrative matters, the suggestion is that the ACC be used to coordinate the substantive policies of the participating institutions, including, specifically, the international financial institutions.

> The time has come for ACC to move from its administrative function, which still remains important, to a 'policy' function required by the new realities of the international situation. That is my recommendation, by which I do not mean that ACC should substitute itself to the deliberative organs of the United Nations or its specialized agencies. The intention is to turn ACC into a body which would provide impetus and effective direction under the chairmanship of the Secretary-General. This change from an administrative to a 'policy' function will not require any lengthy and uncertain process of amending constitutional and other texts. It presupposes however the commitment of the members of ACC. They are the personal advisers of the Secretary-General on all issues relating to the economic, social and humanitarian fields. They are his aides in the preparatory work leading to the adoption of decisions by the General Assembly and the Economic and Social Council, as well as by the deliberative organs of the specialized agencies or of the major Programmes which participate in the work of ACC. Under the leadership of the Secretary-General, they have an individual and collective responsibility, in the areas falling within the mandates of their respective organizations, for following up decisions taken by the General Assembly and the Economic and Social Council,* in the preparation of which their organizations are invited to participate.[25]

*Hence the importance which attaches to the success of the reform of the Economic and Social Council and the Second and Third Committees of the General Assembly. The overall performance of ACC will depend to a great extent on the relationship between it and the Economic and Social Council. Members of ACC should support and assist this reform process.

The proposal, from the point of view of the Fund, raises several issues of substance, extending to the legal nature and structure of the Fund, and the need to review the existing Relationship Agreement. The report, however, fails to grapple with issues of implementation; it fails, in fact, to mention the Relationship Agreement at all.

1C. Issues Regarding the Special Drawing Right of the International Monetary Fund

REINHARD H. MUNZBERG

Intensive discussions took place from 1992 to 1994 on Special Drawing Right (SDR) issues following an unprecedented expansion of the International Monetary Fund's membership. There were two distinct rounds of discussions. First, a proposal for an allocation of SDRs was discussed. Interest focused on the criteria that are relevant to justify an allocation. The second round focused on the possibility of targeting increased amounts of SDRs to particular groups of members, specifically new members of the Fund. This renewed interest in the SDR is a very positive development for the Fund.

History of the Special Drawing Right

The SDR Department was created 25 years ago through the First Amendment of the Articles of Agreement. In the period from 1969 to date, only two decisions to allocate SDRs were adopted. SDRs were allocated in the period from 1970 to 1972 and from 1979 to 1981. The reasons for the absence of more regular allocations are easy to explain: developments did not turn out the way that was initially expected.

The SDR was created against a background of a perceived potential shortage of reserves, in an environment characterized by growing tension in the monetary system and a declining role of gold. The idea was that a mandatory credit-line mechanism backed by a large number of participants, in particular by the major reserve countries, and based on objective distribution criteria, such as Fund quotas, might assist in supplying the reserves that a growing world economy might require. It was also thought that such a supply of reserves should provide unconditional liquidity rather than conditional credit.

When the First Amendment was adopted and when the first allocation decision was approved in 1969, it was expected that the role of the SDR would grow over time as the need for additional reserves rose, and that SDRs would be allocated at a rate that would also be most conducive to attain the Fund's purposes, in particular to assist in the financing of the expansion of trade. However, the early and mid-1970s produced a huge increase in other sources of liquidity and saw the emergence of the Euromarkets. Therefore, when the Fund in 1977–78 turned to a further allocation discussion, it had to assess the justification for an allocation,

particularly in light of the other sources of liquidity that were available to the world economy.

The criterion for an allocation that had been established by the First Amendment had not been changed by the Second Amendment of the Articles in 1978. That criterion requires a finding that there is a long-term global need to supplement reserves through the allocation of SDRs. It was argued by a large group of members that, in light of the abundant availability of liquidity in capital markets, such a need for supplementation did not exist. Ultimately, however, the view prevailed that the particular quality of the SDR, that is, its greater reliability and stability compared to borrowed reserves, needed to be taken into account, and that the finding of global need could not rely exclusively on proving that the need could be met only through SDRs.

In addition, the Second Amendment had added to the Articles the objective of making the SDR the principal reserve asset, and the manner in which that objective should be taken into account in the context of the decision to allocate was explored. When the objective of making the SDR the principal reserve asset was adopted, it was made clear that this objective was not intended to have quantitative relevance, that is, a reduction in the volume of other reserve assets, currencies, or gold would not be required. It was ultimately agreed, however, that in a limited sense there could be a quantitative relevance in that it would be incompatible with the Articles to let the SDR fade away altogether. However, the objective would only be relevant once a finding of global need had been made, and it would not justify an allocation by itself in the absence of global need.

Proposal for a General Allocation

When the Fund returned to an allocation discussion in 1992–93, that discussion focused on a general allocation and, most important, on the reasons that would justify such an allocation. In particular, it was explored whether the needs of a large group of the membership, specifically, countries that had joined the Fund recently, could justify an allocation. The relevant aspect in the provisions on allocations was therefore the concept of "global" need. At that time, the record of that concept was reviewed, and it was confirmed, as had already been explained in the early stages of the establishment of the SDR Department, that the need of individual members or groups of members could not justify an allocation. It was the need of the world economy as a whole for supplementation of reserves that would form a basis for an allocation of SDRs. Moreover, in these discussions, the competition between the SDR and other sources of liquidity

was again reviewed, and the same views that had been expressed in the 1978 discussion were reiterated.

The second round of discussions, in 1993 and 1994, focused more specifically on the issue of targeting SDRs to the new members of the Fund, or in a broader sense, to participants that had not received all allocations of SDRs. It was recalled that, under the Fund's Articles, SDRs can be allocated only through general allocations and only to those members that are participants at the time of the allocation. If a member joins the SDR Department after an allocation, it will receive SDRs only prospectively in future allocations. Moreover, SDRs are allocated on the basis of current quotas of members. There is no selective element in the allocations and no mechanism for catching up through increased rates of allocation with past allocations. Conversely, if a member joins the SDR Department, it will not receive SDRs because of its participation. This treatment of new members, namely, the absence of any selective element or possibility of catching up with past allocations, reflects a deliberate choice by the creators of the SDR. More specifically, this treatment is a function of the nature of the SDR as a mandatory credit-line mechanism, which is backed only by the participants in the SDR Department and therefore requires a broad participation at any point in time, based on objective criteria.

In light of these constraints, a proposal was made to cancel all or part of the existing SDRs and to allocate at least the equivalent amount of SDRs on the basis of current quotas. This proposal, however, faced two main difficulties. First, while the Fund is entitled to cancel SDRs, it can do so only when there is no longer a need for the SDRs created previously to meet the need for additional liquidity. Therefore, the bases for allocation and cancellation are findings in opposite directions, one for more liquidity and one for less liquidity, and it is not possible to make these findings in good faith at the same time. Second, the treatment of new participants in the SDR Department was a result of a deliberate choice made by the membership when the SDR Department was established, and it was therefore not found possible to remedy this result through interpretation or through the application of implied powers.

The Executive Board was again invited to report on SDR issues to the Interim Committee in September 1994, which shows that the effort to increase the volume of SDRs and to make SDRs available to all members continues.

Chapter 2

Developments at the International Bank for Reconstruction and Development: The Restructuring of the Global Environment Facility

ANDRÉS RIGO

Introduction

In March 1994, 73 countries met in Geneva and agreed to restructure the Global Environment Facility (GEF), created three years earlier as an experiment of international cooperation to finance activities for enhancing the global environment.[1] The restructuring of the GEF is the first tangible follow-up to Agenda–21 of the United Nations Conference on Environment and Development (UNCED), held in Rio de Janeiro in 1992.[2]

The GEF has unique features that make it an interesting case study of an international organization: how existing structures are used to achieve new objectives, how they are modified in the process, and how new structures come into being.

Pilot Phase

The origins of the GEF trace back to the United Nations Environment Program (UNEP), established by the General Assembly as a result of the 1972 Stockholm Conference on the Human Environment.[3] In its early work, UNEP started to define the global environmental issues in support of which, 20 years later, the financing mechanism of the GEF was created. More direct precedents are the report of the 1987 World Commission on Environment and Development (known as the Brundtland Report), which recommended the establishment of a facility to finance conservation projects and national strategies, and nongovernmental organization initiatives such as the report prepared in 1989 by the World Resources Institute, *Natural Endowments: Financing Resource Conservation for Development.*[4]

At the Development Committee meeting of 1989, a proposal was put forward by the French representative to establish an environment facility. The German delegation presented a similar proposal. At that meeting, the International Bank for Reconstruction and Development (the Bank)

was asked "to assess the requirements for additional funding and explore the potential for donor support for addressing global environmental concerns in developing countries."[5]

The Bank consulted with the donors, several developing countries, the United Nations Development Program (UNDP), and UNEP. As a result of these consultations, the Bank presented to its Board of Executive Directors a memorandum attaching a formal resolution for approval to establish the GEF. The proposal was approved on March 14, 1991 and later endorsed by the Governing Councils of UNEP and the UNDP. In October of the same year, the Bank, UNEP, and the UNDP signed an agreement on operational cooperation under the Global Environment Facility.[6] This agreement detailed the responsibilities of each of the implementing agencies. They were expected to collaborate according to their respective "comparative advantage."[7] The Bank retained responsibility for the Global Environment Trust Fund (GET), the chairmanship of the Facility, and the Secretariat. In terms of the operational responsibilities of each agency, the Bank is responsible for investment operations, the UNDP administers technical assistance, and UNEP coordinates research and provides guidance for selecting and evaluating projects through a group of 15 scientists, the Scientific and Technical Advisory Panel.

Participation was open to all states provided that they contributed amounts equivalent to at least SDR 4 million over eight years. In the case of developing countries, the Bank was prepared to contribute half this amount. During the pilot phase, participants in the GEF met twice a year to review the operations and co-financing arrangements on the basis of reports prepared by the Bank, after consultation with UNEP and the UNDP. The participants reviewed the overall policy framework and the work programs of the three implementing agencies. There was no provision for a voting system in the meetings of the participants: "[i]t was presumed that the Bank, which chairs these meetings, would follow the sense of the meeting as summed up by the Chairman."[8]

The GEF finances projects that are deemed to benefit the global, as opposed to the local, environment, in the areas of global warming, pollution of international waters, biological diversity, and depletion of the stratospheric ozone layer from emissions of chlorofluorocarbons and other gases. The GEF had pledges amounting to about SDR 1 billion for the three-year pilot phase (1991–94) from three different sources: the so-called core fund (the GET), associated co-financing arrangements, and the funds provided under the Montreal Protocol to help developing countries comply with its provisions to phase out ozone-destroying substances.[9]

Interim Multilateral Fund

It is illustrative in the context of the restructuring of the GEF to dwell briefly on the Montreal Protocol.[10] This protocol to the Vienna Convention for the Protection of the Ozone Layer[11] requires both developing and developed countries to reduce the production and consumption of chlorofluorocarbons, but it does not have a specific mechanism to meet the substantial costs of developing countries that are adopting substitutes for ozone-depleting substances. The issue of financing mechanisms was raised by France in the Development Committee in 1989 at the same time that the proposal for the GEF was first tabled. The ensuing negotiations led to the establishment of a fund for the purposes of the Montreal Protocol, the Interim Multilateral Fund, to assist developing countries in meeting their obligations under the protocol for a period of three years starting January 1, 1991.

For purposes of the operation of the Interim Multilateral Fund, an Executive Committee was established with 14 members, 50 percent of which are from industrialized countries and 50 percent from developing countries that are potential beneficiaries of this fund. The Executive Committee develops policies, plans, budgets, and criteria for project eligibility; it also approves country programs for compliance and cooperates with the implementing agencies according to their respective areas of expertise. The functions of the three agencies are similar to those under the GEF. The parties to the protocol meet once a year, and each of the agencies has entered into a separate agreement with the Executive Committee for carrying out the activities to be financed. The agreement of the Bank with the Executive Committee of the Interim Multilateral Fund provides for an Ozone Projects Trust Fund to be financed out of the Interim Multilateral Fund, which became permanent in 1992.[12] The Bank is the trustee only of the funds for the projects for which it is the implementing agency. Funding for the years 1994–96 will amount to approximately $500 million, from assessed contributions by all parties to the Montreal Protocol, based on the UN contribution scale.

The New GEF

As early as 1992, the participants of the GEF agreed that its structure should be adjusted so that it could play a permanent role beyond the pilot phase. For this purpose, a number of principles were agreed providing, inter alia, that "the GEF should build on proven institutional structures, such as the partnership among UNDP, UNEP, and the World Bank, thus avoiding the creation of new institutions," and that the GEF would

be "transparent and accountable to contributors and beneficiaries alike."[13]

Agenda–21 of UNCED, the United Nations Framework Convention on Climate Change, and the United Nations Convention on Biological Diversity also called for the restructuring of the GEF as a prerequisite for its designation as the financial mechanism of these conventions.[14]

The negotiating process, which concluded in March 1993, lasted two years and required seven meetings of the participants. During this drawn-out process, the replenishment negotiations and the changes in the structure interplayed, nearly placing the process in jeopardy. The role of the Bank, the apportionment of the contributions, voting, and the "institutionalization" of the GEF as a distinct entity were among the topics that attracted the most attention. The result is a $2 billion fund entrusted to the Bank and the Instrument for the Establishment of the Restructured Global Environment Facility.[15]

The GEF has become universal. Any state that is a member of the UN or its specialized agencies may become a party and does not need to contribute to do so. The GEF has an elaborate structure, which may be contrasted to the meetings of the parties and the secretariat in the pilot phase. It has now an Assembly, a Council, and a Secretariat.[16] The Assembly consists of representatives of all participants but meets only once in three years, that is, once during the replenishment period. Its function is one of reviewing the GEF's membership, its policies, and its operation.

The Council will be composed of 16 members from developing countries, 14 from developed countries, and 2 from countries with economies in transition. The Council will meet semiannually. The chairmanship shall alternate from one meeting to another between recipient and nonrecipient Council members. The Chief Executive Officer (CEO) will cochair the meetings. The Council will approve the work program, and individual projects within the program will be developed and approved by each of the agencies. The CEO will endorse each project before final project approval. The Council may review a project prior to final approval by the agency concerned if at least four Council members so request.

The Secretariat is to service and report to the Assembly and the Council. The Secretariat will be supported by the Bank but be functionally independent. The CEO is to be appointed for three years by the Council on the joint recommendation of the implementing agencies.

The implementing agencies continue to be the same and they are expected to make arrangements with other institutions—multilateral, pri-

vate, or public—for preparation and execution of GEF projects. A new Scientific and Technical Advisory Panel will be established by UNEP in consultation with the other agencies and on the basis of guidelines and criteria established by the Council.

Decisions of the Assembly and Council normally will be taken by consensus. In the case of the Council, if consensus is not reached, any member may ask for a formal vote. A formal vote requires a double-weighted majority: an affirmative vote representing 60 percent of the total number of participants and 60 percent of the total contributions.[17]

Implications of the New GEF

The negotiating process, the instrument negotiated, the resulting structure of the new GEF, and how they fit in a wider context merit the following comments.

Negotiating Process

The negotiating process was open not only to donors but also to all states, as opposed to the pilot phase negotiation, which was donor driven. The more active participation of the beneficiaries has deeply influenced the results. In this respect, the negotiations reflected the North-South confrontation that has come to characterize the negotiations of environmental conventions in recent years. They reflected the concern for efficiency of the donors, as opposed to the concern for equity of representation of developing countries. The latter consider it their right to develop and to use their own resources, bearing in mind the pollution generated in the North.[18] Thus, it is not surprising if the umbrella mechanism of the GEF emerging from these negotiations is not that different in structure from the institutional arrangements established under the various environmental conventions. In this respect, the Executive Committee of the Montreal Protocol can be seen as a starting point for the new GEF and the Conventions on Climate Change and Biological Diversity.[19] A noteworthy input in the negotiating process is the independent evaluation of the GEF requested by the participants at the end of 1992, which, completed a year later, had an impact on the later stages of negotiations.

Instrument Negotiated

The instrument negotiated is not a treaty, although the negotiations gave the impression that one was being negotiated. In the end, it is an instrument negotiated by governments, but it will not be ratified by them

as a treaty would be. The instrument was formally adopted by the Board of Executive Directors and the Board of Governors of the World Bank, as well as by the Governing Councils of UNEP and the UNDP.[20]

Any amendment or termination must be approved by the Assembly upon the recommendation of the Council, but it becomes effective only after each of the implementing agencies and the Bank, as trustee, adopt it in accordance with the respective rules and procedural requirements.

Resulting Structure

The resulting structure resembles very closely that of a new international organization, except that the negotiated instrument refrains from specifically saying so and from giving the organs of the GEF the power to contract. This lack of a separate personality is reflected in several of the ways in which the new GEF is expected to operate. For instance, the relationship of the GEF with the Climate Change and Biological Diversity Conventions is to be approved by the Council, but the instruments embodying it in the form of agreements or arrangements are to be formalized by the Bank as trustee.

This raises the question, When does an entity come to exist independently from its sponsors? While the Conference of the Parties to the Conventions on Climate Change and Biological Diversity and the Executive Committee of the Montreal Protocol are considered to have juridical capacity to contract, the GEF Council or the Assembly apparently will not have such power.

In the wider context of international cooperation, the GEF is an interesting experiment to maximize the comparative advantage of existing institutions without creating new ones. While the cooperation has not been perfect, it has worked sufficiently well to keep the GEF as the basic arrangement for financing and implementing environment projects in the future. As restructured, the GEF provides an umbrella for cooperation and consultation to implement the objectives of framework conventions as individual protocols are added. It appears to be a valid counterpoint on the financial side to the treaty-making style that has developed in the environment area. It is sufficiently practical and flexible to adapt to an evolving field while making use of existing structures.

The coordination of the structures set up under each of the conventions and the GEF itself will no doubt be a test of the system. To the extent that the Ozone Projects Trust Fund can be considered a precedent, it has worked reasonably well; however, there might be more of an overlap in the future between the GEF itself and the structures of each one of the conventions.

Chapter

3 Developments at the International Finance Corporation

JENNIFER A. SULLIVAN

The International Finance Corporation (IFC) is a member of the World Bank Group that promotes development in its member countries by supporting the private sector. The IFC is the world's largest source of direct investment for private project finance in developing countries. Since it began operations in 1956, the IFC has financed over twelve hundred business ventures in more than one hundred countries.[1]

In recent years, the trend throughout the world has been to move away from government control of the economy and toward greater encouragement of private initiative and the development of a viable private sector. The sweeping reforms in Central and Eastern Europe, the Baltic countries, Russia, and the other countries of the former Soviet Union are the most obvious example. These changes in the political and economic climate have confronted the IFC with a special challenge and a special burden.

IFC's Role as Investor in the Private Sector

The IFC's principal traditional activity is as a project lender or investor. Using its own funds, the IFC lends money to, and invests equity in, private sector projects whose prospective earnings, the IFC believes, are likely to be sufficient to meet debt service and to earn an acceptable return on equity. Projects must also benefit the local economy and be environmentally sound. Unlike the World Bank itself and many other multilaterals, the IFC does not accept government guarantees of its loans or equity investments. Although, as a rule, the enterprises financed by the IFC are wholly or majority privately owned, the IFC may provide finance for a company with minority government ownership, provided that the private sector is participating and the venture is operated on a commercial basis.

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

Another important IFC function is as a mobilizer of resources. The IFC raises additional funds for projects from other lenders or investors that derive comfort from the IFC's involvement. In the IFC's "B" Loan

Program, the IFC is the lender of record but is itself funded by commercial banks through participation agreements that the IFC signs with such banks. In fiscal year 1994, for every dollar that the IFC approved for its own account, it mobilized about six dollars from other investors.[2]

The IFC also mobilizes finance through the capital markets. For example, the IFC may sponsor and underwrite portfolio funds for investing in local markets or arrange and underwrite international securities issues by companies from emerging markets.

Current Developments

Privatization

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

Frequently, the IFC starts by providing technical assistance in areas such as securities market development and privatization. When warranted, the IFC makes investments directly in medium- and large-sized private enterprises. It also fosters the development of smaller enterprises through investments in the country's capital markets, for example, by providing credit lines through financial intermediaries and financing venture capital and leasing companies.

Noteworthy advisory assignments have involved preparing and implementing, with financing from the U.S. Agency for International Development and the U.K. Know-How Fund, the privatization of thousands of small enterprises in Russia, as well as scores of small firms in Ukraine.[3] The IFC designed an auction method for privatization that is being used as a model in both countries. An estimated 70,000 small businesses have now been privatized in Russia using this method.[4] In Russia, the IFC also participated in the privatization of trucking firms and collective farms in one region, and both of these projects are now being used as models for other regions.

Power Sector B.O.T. Projects

Significant changes are under way in the financing of basic infrastructure. Many governments are now looking for private capital for infrastructure investments, as well as for investments in telecommunications, power, ports, roads, and the like, which were formerly financed exclusively by the public sector. For example, power projects frequently involve high capital costs and long payback periods, thus requiring long-term financing. However, private power projects may find it difficult to attract foreign direct investment. Typically, a private power project might have only one purchaser for its power, often a public utility that, owing to a subsidized tariff structure, is not creditworthy. In many cases, privatized companies have no track record, so there is no basis for judging their performance. In addition, few lenders worldwide have experience in financing private power projects because the power sector has not historically been open to private companies in the developing world. Foreign investors are particularly cautious because power projects are not export oriented and thus do not generate hard currency. Furthermore, revenues are often subject to the rate-setting policies of government agencies. Most export credit agencies are used to the comfort of government guarantees and are just beginning to accept the concept of nonrecourse or limited-recourse project finance. The IFC therefore has played an important catalytic role in power projects by attracting other investors.

A popular option today for power projects is based on the B.O.T. Model, by which a private company *b*uilds, *o*perates, and, after several years, *t*ransfers to the government a privately financed power plant. The IFC has financed B.O.T. projects for new power stations in Asia and Latin America and is currently considering a number of such power projects in other regions. Most recently, the IFC completed, as lead financial adviser and lender, the structuring and arranging of the financing for a 700-megawatt coal-fired plant to be constructed on a B.O.T. basis in the Philippines, with a project cost in the range of $900 million.[5]

Typical Power Project Arrangement

In order to mitigate the risks and attract the necessary capital to the private power sector, one of the IFC's main objectives in B.O.T. projects is to ensure an adequate revenue stream for debt repayments. Therefore, the contractual arrangements, particularly a strong power purchase agreement and provision for any potential conditionality affecting the revenue stream, are important.

Regulatory Agencies

Equally important to the strength of the project agreements are stable relationships with the regulatory agencies. Because of the IFC's long and close relationships with its member governments, the IFC's participation in a project is often viewed as a sign to investors that a company's relationship with the government will be stable.

Foreign Exchange Risk

Because most power projects generate local currency revenues, potential foreign investors are concerned about the foreign exchange risk. To address this risk, lenders typically require local currency payments to be adjusted for changes in the foreign exchange rates on the date of payment. Depending on the circumstances, lenders may also require some assurances regarding convertibility or that some level of reserves of foreign exchange be maintained in offshore accounts.

Commercial Risks: Construction and Completion

Lenders typically will not assume much completion risk in power projects. The project company is expected to hedge this risk through use of a fixed-price, date-certain, turnkey contract that contains warranties and provisions for performance bonds and liquidated damages if the contractor fails to perform (and bonuses for better-than-expected performance). Lenders may also require at least a limited completion guarantee that commits the sponsors jointly and severally to complete the project through additional equity injections or subordinated loans up to an agreed capped amount based on a worst-case scenario.

Political and Governmental Risks

The IFC has found that lenders typically require the purchasing utilities and governments to assume the risk of uninsurable or political and governmental force majeure both during construction and operation. To achieve this, the power purchase agreement with the local utility provides that the utility is not excused from making that portion of payments necessary to service debt if any of the enumerated events occurs. Alternatively, or in addition, the utility sometimes agrees to purchase the project at fair market value if certain force majeure events occur.

Government's Performance Undertaking

If the state-owned utility is perceived to be insufficiently creditworthy or the tariffs that the utility charges to its customers are not set by an

independent regulatory agency, sponsors and lenders also typically require the government to provide some level of backup support of the utility's payment and other obligations under the power purchase agreement.

New Products

As more countries are encouraging private entry into the power sector, the IFC is working to respond to the increased demand, focusing particularly focus on capital market development. The IFC is investing in specialized infrastructure funds, underwriting bond issues, and, in Hungary, borrowing for itself local currency for on-lending locally, a product that would be particularly suitable for power projects, which generally do not earn foreign exchange.

COMMENT

WILLIAM M. BERENSON

Global Environment Facility

The Global Environment Facility (GEF) was recently restructured. It was not restructured as an international treaty organization, but rather to use existing administrative facilities and structures within the participating agencies. This is an experiment. The Secretariat for the administration of the Global Environment Trust Fund (GET) is now within the World Bank and will be operating under the legal personality of the World Bank, as the agency itself will not have a legal personality.[1] Although the agency, in its restructuring, is not an independent legal personality, it has taken on some of the trappings of treaty organizations. The Secretariat has a Chief Executive Officer appointed every three years. It has an Assembly (or what is called a Board of Governors in some international financial institutions), which is made up of the member states and which will meet every three years to establish general policy directives and make general decisions about the direction of the institution.[2] The GEF has a Governing Council, which meets twice a year and which is composed of 16 members from the so-called industrialized countries, 14 members from the so-called developing countries, and 2 from countries in economic transition.[3] Finally, there is a panel of distinguished scientists, the Scientific and Technical Advisory Panel, which will be established within the United Nations Environment Program (UNEP) and offer technical advice to the GEF. The United Nations Development Program (UNDP), in its role, will provide direct technical assistance to the member states. Thus, these three executive agencies, UNEP, the UNDP, and the World Bank, are under umbrella direction from the Council and from the Assembly within their special competences.

Another interesting structural aspect of the GEF is the method of voting. Previously, the GEF lacked formal rules for voting. Now, while there is the aspiration that it can do everything by consensus, if consensus fails, a provision has been made for the use of a double-weighted method of voting: a vote representing 60 percent of the contributions and 60 percent of the total membership will carry a proposal (if consensus cannot be made in either the Council or the Assembly).[4]

This interesting structure could be a model in the future for other institutions within the international organizations community. The idea of preventing a proliferation of new secretariats requiring additional contri-

butions for administrative exercises is a positive one in the world of international organizations.

Developments at the International Finance Corporation

There are four criteria that the International Finance Corporation (IFC) primarily looks for when making its loans to support private sector development:

- the economic (or earning) stream of the project;
- the sufficiency of the revenues generated by the project, that is, will they sufficiently pay back the capital and support debt service?
- the benefits to the local economy that the project will provide; and
- the environmental soundness of the project.

The fourth criterion, environmental soundness, has been increasing in importance in international projects over the past 10–15 years, and particularly since the UN conference on the environment held in Rio de Janeiro and the establishment of the GEF.

Power projects fall within a range of infrastructure projects, including telecommunications, highways, and waterworks, that used to be largely government owned and operated. Now, however, there is a tendency for power-generating facilities to be placed in private hands or to be developed by private businesses. A new spirit of privatization seems to have enveloped most of the world over the past ten years. In funding a power project, the IFC often uses the B.O.T. Model, in which a private company builds the facility, operates it for a couple of years, and then transfers it to the government.

The major concern for the IFC in this kind of a development project is whether the resulting revenue stream will be sufficient to pay off the capital cost and the debt service. Other concerns, as well, are of particular interest. For example, will there be a stable relationship with the regulatory entities? Often these facilities are not owned by governments, but by private parties. Some may be eventually transferred back to governments. The power utilities buying the power, however, may be private companies; they may have tariffs that are subject to governmental regulations; and there may be licensing requirements and safety and environmental standards. The necessity of compliance with those standards is important because compliance has a cost, and, as costs increase, profits may go down. Therefore, information is needed regarding the stability of the relationship with the regulatory entities. Also, there is the question of how likely it is that additional regulatory requirements will be imposed

that will make the investment less attractive and result in insufficient revenue to fund the debt service and a return of the capital.

Another important question, which is critical to foreign investors and to financial institutions investing in a country, relates to exchange risks. Foreign investors want to make sure that they can get their money out. Are there provisions in the local law that prohibit or obstruct repatriation of capital and profit? Corporations, private banks, and central banks will ask, "What kind of assurances can we get from the government? What kind of procedures are going to be in place? Are these going to be complicated or simplified?"

Still another factor that foreign investors look at is completion risk. There is an element of completion risk in every project, whether privately or publicly financed. An investor who is financing a project wants to see the performance bond, the completion bond, and provisions for liquidated damages if the project is not completed in a timely fashion.

Other considerations include, How creditworthy is the entity that is going to be buying the power? Is it going to pay its bills? If it is a private entity, what happens if it becomes insolvent? Is it subject to government guarantees? There must be revenue streams. If the buyer of the power goes out of business or cannot pay its bills because it has other demands, the project is a bad investment. Therefore, the buyer's creditworthiness must be investigated, and the investor should obtain and secure the necessary guarantees, in order to be sure that the investment is going to be secure.

Investment in Legal Infrastructure

Many countries will need to make investments in their legal infrastructure, including arbitration facilities, and take other measures for the resolution of disputes between investors and public entities. Investors must be confident that the justice system is fair. These countries will have to train people, invest in equipment, and build new courthouses. The investment cannot be a onetime affair; it has to be a continual process.

The greatest legal structure in the world can be designed, but if the administration of that system is not funded, it does not do anybody any good. The system must attract and keep good talent. Salaries that are competitive with the private sector must be paid in order to get the best talents into the system. Otherwise, it will fail. There should not be a revolving door, through which people come and go. This leads to conflict-of-interest problems. Also, the staff must be paid enough money so that it does not become dependent upon the people whom it regulates.

This problem of regulators being captured by the regulated must be avoided. The only way that it can be done is by making sure that the administrative law structure has adequate resources.

Chapter 4 | The First Three Years of the European Bank for Reconstruction and Development: Legal Issues and Solutions

ANDRE NEWBURG

Introduction

In a paper summing up the role played by law in the affairs of the International Monetary Fund, its former General Counsel, Sir Joseph Gold, wrote that the IMF is "an economic organization, but one in which great weight is attached to the law of the institution. . . ."[1] The task of IMF lawyers, he noted, "has been to find within the law solutions for the many problems that arise" in the institution's life. In doing so, they have developed a "discrete branch of public international law" that might be called "international monetary law."[2]

The important function of law described by Sir Joseph Gold has also characterized the young life of the European Bank for Reconstruction and Development (EBRD or Bank). As in other international financial institutions, the constitutional law of its charter has shaped the development of EBRD policy and practice. This chapter will examine some legal issues that have arisen during the Bank's initial years. It first refers to those elements of the Bank's charter that differ from the charters of other international financial institutions, particularly the political and environmental aspects of the Bank's mandate. The chapter then addresses issues arising from the dramatic changes in the countries constituting the Bank's membership; the private sector focus of the Bank's charter; and the Bank's relationships with other international financial institutions.

The EBRD's Charter and Unique Mandate

Despite the close affinity with its international financial institution siblings, the law of the EBRD is different. Two key distinctions are its youth and its unique mandate. The Bank began operations in April 1991.[3] Therefore, EBRD lawyers, unlike their counterparts in other international financial institutions, do not benefit from a long line of internal precedents for guidance. To some extent, they can rely on the earlier interpretations and practices of other international financial institutions, especially the International Bank for Reconstruction and Development (the World Bank or IBRD) and the IMF, which have developed over the

decades a vast body of precedents. The drafters of the Agreement Establishing the European Bank for Reconstruction and Development (the Agreement) quite sensibly sought to draw on the experience of those more mature institutions in formulating the Bank's structure, and parts of the Agreement closely resemble the Asian Development Bank's and the World Bank's charters.[4] Those charters have been interpreted and developed in regulations, policy papers, operational guidelines, legal opinions, and decisions by governing bodies. In areas where the Agreement follows the charters of other international financial institutions, the EBRD has looked for guidance to the practices of its sister institutions and has benefited greatly from interpretations developed over the years by them.[5] However, as several of the Bank's more novel features have no parallels in other institutions, many of the issues faced by the Bank have presented new questions of law and policy.

While providing a model for the Bank, the existence of the other international financial institutions also made it necessary to define carefully the functions of the new institution. The drafters attempted to carve out a role for the Bank that would complement and not duplicate that of other institutions. The result is an institution that in various respects differs markedly from its sister institutions.

First, the Bank was formed specifically to support the transformation of the countries of Central and Eastern Europe into market-oriented democratic societies. Article 1 of the Agreement states:

> [T]he purpose of the Bank shall be to foster the transition toward open market-oriented economies and to promote private and entrepreneurial initiative in Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism and market economics.[6]

Article 8 of the Agreement strengthens this purpose by providing that the Bank may operate only in countries "proceeding steadily in the transition toward market-oriented economies" and that apply "the principles set forth in Article 1. . . ."[7]

Second, the Bank has a specific environmental mandate. It is required to promote, in all of its activities, "environmentally sound and sustainable development."[8]

Third, the Bank has a specific private sector focus. Article 2 states that the Bank shall promote "private and entrepreneurial initiative."[9] The Bank therefore combines under one roof the functions of a merchant or investment bank with those of a development bank.[10] It finances the emerging private sector with equity investments and loans, and it finances

public sector infrastructure necessary for private sector development and the proper functioning of a market economy.

Fourth, the Bank is the first international financial institution in which the countries of Eastern Europe the Baltic countries, Russia, and the other countries of the former Soviet Union were not only founding members but were also represented on its Board of Directors.

The political and environmental aspects of the Agreement are unique characteristics of the Bank. The charters of other international financial institutions prohibit them from being influenced by political considerations or by the political character of their members, and these charters do not contain provisions explicitly requiring attention to environmental concerns.[11] Although this has not prevented the World Bank from taking human rights and environmental considerations into account in its operations, it may to some extent have constrained its scope for action on these issues.[12]

Underlying the political objectives reflected in the Agreement is the conviction that economic development is closely linked to political democracy, the rule of law, and respect for human rights. These goals have been added to the international community's long-standing concerns for development and economic growth as instruments for the alleviation of poverty. As the EBRD's President, Jacques de Larosière, stated at the Bank's 1994 Annual Meeting in St. Petersburg:

> Success in [the direction of structural reform] requires that the population understand the significance . . . of reforms which may be painful in their immediate consequences. Hence the importance of the strengthening of and progress toward democracy that the EBRD must take into account in its own activity.[13]

Procedures to implement the political aspects of the EBRD's mandate are set out in a 1991 policy paper.[14] Political and economic progress is to be assessed annually, in the Bank's country strategies, rather than on a project-by-project basis. The Bank attaches particular importance to those civil and political rights that are essential elements of multiparty democracy. Ratification of the European Convention on Human Rights and admission to, and good standing with, the Council of Europe are regarded as positive indicators of a country's commitment to the principles of multiparty democracy.[15] In evaluating the progress being made by a country toward the rule of law and democracy, the Bank consults with, and relies substantially on, the views of the Council of Europe, the Conference on Security and Cooperation in Europe, and other international bodies with special expertise.

If a member were to implement policies inconsistent with the Bank's purpose, the Board of Directors is required to consider whether the country's access to Bank resources should be suspended or modified.[16] However, the Bank not only monitors the political events in the countries in which it conducts operations, but it also may provide assistance in strengthening the rule of law and democratic institutions.[17] Economic, as well as political, objectives can be served by such assistance. Without effective legislative and institutional reforms, transparency, accountability, due process, and reliable means of legal redress, there will be no large-scale foreign investment in the countries of Central and Eastern Europe.

In tandem with the Bank's political mandate and also unique among international financial institutions is the Agreement's special emphasis on the environment. The Agreement lays out an environmental mandate that requires the Bank to "promote in the full range of its activities environmentally sound and sustainable development. . . ."[18] Although other international financial institutions have adopted similar policies because of recent controversies over the environmental aspects of their activities, the Agreement is the first such charter that expressly recognizes the increasing public concern for the environment.

The environmental mandate both indicates a general direction for the Bank's investment policies and places limits on the Bank's operations.[19] The Bank does not finance projects that do not satisfy its environmental standards. Its environmental policies and procedures require all projects to be screened for potential environmental impact at an early stage. If projects are deemed environmentally sensitive, they are subject to more extensive assessments. In cases that involve the transfer or lease of property, or the modification of existing facilities, an environmental audit is also required. The Bank's environmental standards are based generally on those of the European Community, although Bank policy recognizes the need, on occasion, for the use of "more stringent environmental standards in areas which suffer from high levels of pollution or are ecologically fragile."[20] The Bank also seeks to promote environmentally sound projects. An outstanding example is the Nuclear Safety Account, established with the Bank in 1993 by 13 countries and the European Community for the purpose of providing grants for urgent safety improvements in nuclear power reactors in countries of the region.[21]

It is early yet to judge the extent to which the distinctive features of its charter have furthered the Bank's overall mission. A positive assessment, based on the first three years of operations, was given by the Bank's President at the 1994 Annual Meeting when he described the Agreement as having created "an ideal vehicle for effective action."[22]

Membership Issues

Soon after its inauguration, the Bank had to face in rapid succession a number of issues relating to the admission of new members and the dissolution of countries that had been founding members of the Bank. Although decisions regarding eligibility for, and the terms and conditions of, membership are within the exclusive competence of the Bank's governing bodies,[23] the Bank's actions in this regard had to be taken against the background of the policies of its members and other international bodies.

Even before the coming into force of the Agreement, the German Democratic Republic, which had signed the Agreement as a "recipient country," ceased to exist as a result of German reunification on October 3, 1990.[24] Germany decided not to take up the 15,500 shares (1.55 percent of the Bank's capital) allocated to the former German Democratic Republic and did not seek access to the Bank's resources available to the Länder of that former country. In any event, it would seem difficult to sustain the position that assistance to a region that had become an integral part of Germany would be consistent with the purpose of the Agreement.[25] By a decision of the Board of Governors, the shares that had been allocated to the former German Democratic Republic were added to the shares that had been designated as nonallocated in the Agreement and were made available for subscription by new or existing members.[26]

Although several non-European countries, including Brazil and India, indicated an interest in membership, it soon became evident that there would be a need first to earmark nonallocated shares for subscription by new regional recipient members. In July 1991, Albania became the first new applicant for membership. A few months thereafter, applications were received from each of the three Baltic countries, which had declared their independence from the U.S.S.R. In each case, the country had been recognized by substantially all member countries.[27]

Dissolution of the U.S.S.R.

The dissolution of the U.S.S.R. at the end of 1991 and the emergence of the countries of the former Soviet Union as independent states raised a number of novel and complex issues that required rapid resolution if the Bank's ability to operate in the entire territory of the former Soviet Union were not to be disrupted. As the U.S.S.R. had not been a member of the World Bank Group or of any other multilateral financial institution, the Bank had to develop its own doctrine on a basis that would

be acceptable to its membership, as well as to the Russian Federation and the other countries of the former Soviet Union that were prospective members of the Bank.

In order to continue preparation for Bank operations in Russia and the other former U.S.S.R. countries, it was important to formulate an approach under which U.S.S.R. membership could be regarded as having provisionally devolved upon them pending the resolution of various issues. Accordingly, early in January 1992, a proposal was submitted to the Board of Directors under which the "successor" states of the U.S.S.R. would continue "in principle" to be eligible for Bank operations, provided that they expressed the desire "to continue" membership in the Bank and to adhere to the Agreement. At the same time, consultations were undertaken to ensure consistency with the views of the Bank's other member countries in respect of the succession to the U.S.S.R.

It soon became apparent that many members wished to treat the Russian Federation as the sole successor to the U.S.S.R. in the Security Council and other UN bodies, and to its rights and obligations under various international treaties. The United States especially wanted to establish the Russian Federation as the successor to the U.S.S.R.'s obligations under strategic arms reduction agreements. As a number of the former countries of the Soviet Union are located in Asia, the question also arose of whether all the republics could be considered "European" so as to satisfy the eligibility criteria of the Agreement.[28] A related issue was that, as the Asian countries could be eligible for membership in the Asian Development Bank (ADB), membership in the EBRD might be incompatible with the view of some countries that a "recipient" country should not be a member of more than one regional multilateral development institution.

After considerable discussion, the Board of Directors adopted a policy that sought to accommodate these concerns while meeting the Bank's objective of maintaining continuity of operations pending the completion of membership procedures.[29] Under this approach, upon dissolution of a member country, its shareholdings are divided among the states that had been part of its territory and that "the Board of Governors of the Bank determines, for purposes of the Agreement Establishing the Bank, to be the states upon which the membership devolves."[30] In each case, membership is conditioned on confirmation by the country that it wishes to adhere to the Agreement and is "committed to the Bank's purpose as described in Article 1 of the Agreement."[31] Moreover, if a country had been part of the territory of a dissolved recipient member country, it will for purposes of the Agreement retain its status as a Central or Eastern European recipient country. The Board of Directors also determined that

nothing in the Agreement would bar a recipient country from also being a member of another "regionally focused international financial institution," although it noted that the Board of Directors might wish to take such membership into account in formulating the operational strategy for that country.[32]

As the Bank's members wished to ensure that the aggregate shareholding of the 12 countries of the former Soviet Union would not exceed the shareholding of the former U.S.S.R., it was necessary to obtain the agreement of each of the 12 countries of the former U.S.S.R. to a division between them of the 60,000 shares held by the U.S.S.R. A tentative allocation was proposed by the Bank, and, by the end of February 1992, an agreement had been reached by which the Russian Federation retained two-thirds of the shares and the balance was divided among the other countries. Each country was credited with its pro rata share of the initial stock subscription payment that had been made by the U.S.S.R. and undertook to pay the remaining installments. As a result, it was possible to admit the Russian Federation to membership prior to the Bank's first annual meeting in April 1992. By December 1992, the 11 other countries of the former Soviet Union, having completed the necessary formalities, had also become members.

Limitation on Operations in the U.S.S.R.

As a result of the dissolution of the U.S.S.R., the Bank had to deal, much sooner than had been expected, with the controversial question of the limitation on Bank operations in the U.S.S.R. This limitation reflected a complex compromise that had been reached in the last stages of the negotiation of the Agreement in an effort to dispel the concern of some countries, principally the United States, that the U.S.S.R. could absorb the vast majority of the Bank's resources. It also reflected skepticism about the extent to which the U.S.S.R. at the time was prepared to move toward multiparty democracy and a market economy.[33] In order to avoid singling out the U.S.S.R. and putting it on a different footing than the other recipient countries, an intricate solution was devised. Article 8.4 was added to the Agreement, permitting any recipient country to request the Bank, for a period of three years after the entry into force of the Agreement, to provide access to its resources only for "limited purposes" and in an amount not in excess of the payments made by that country for its shares.[34] Such a request was to be "attached as an integral part" of the Agreement.[35]

Prior to signature of the Agreement, the head of the Soviet delegation, Victor Gerashchenko, addressed a letter to the Chairman of the Conference on the Establishment of the European Bank for Reconstruc-

tion and Development, acknowledging the "fears of a number of countries that due to the size of its economy the Soviet Union may become the principal recipient of credits of the Bank" and stating that his Government was prepared to limit its access to the Bank's resources pursuant to Article 8.4.[36] Moreover, although the Gerashchenko letter expressed confidence that continuing economic reforms in the Soviet Union could "inevitably promote the expansion of the Bank's activities into the territory of the Soviet Union," it went on to state that the U.S.S.R. "will not choose that at any time in future the Soviet borrowings will exceed an amount consistent with maintaining the necessary diversity in the bank's operations and prudent limits on its exposure."[37]

With the dissolution of the U.S.S.R., it became evident that, while the Bank's activities in all 12 countries of the former Soviet Union could in principle be limited to technical assistance and the other types of financing permitted by Article 8.4, it was impracticable to apply the quantitative limitation to these prospective new members. In any event, it was clear that these countries would not wish to join the Bank on terms that, even for a limited period, provided them with no net new resources. However, significant differences of opinion remained as to the appropriate manner in which the limitation should be removed. Although the Gerashchenko letter had been a unilateral request, it now was "attached as an integral part of the Agreement."[38] While Article 8.4 envisaged that the limitation could be removed by a supermajority vote of the Governors, it permitted such action only at the end of a period of three years from the coming into effect of the Agreement.[39] A few members took the position that, as a legal matter, the Gerashchenko letter could be "detached" only by an amendment of the Agreement. This was likely to be a lengthy process as it required the approval of three-fourths of the member countries representing not less than 85 percent of the total voting power and, in some countries, parliamentary procedures.[40]

The General Counsel advised the Board of Directors that the particular characteristics of the U.S.S.R. at the time of signature of the Gerashchenko letter had constituted an essential basis for the limitation and that the dissolution of the U.S.S.R., which had not been foreseen or contemplated at the time, radically transformed the basis and framework of the limitation. Although this could under general principles of international law be considered a fundamental change of circumstances justifying its termination,[41] it was not necessary to rely solely on this principle. The power of interpretation accorded to the Board of Directors by the Agreement is designed to give the Board adequate latitude to enable the Bank to pursue its objectives in the changing conditions under which it operates.[42] In these circumstances, an interpretation by the Board of Directors that the limitation was no longer applicable would be

consistent with the Agreement. This approach also appealed to several member countries that were concerned that viewing the dissolution of the Soviet Union as a fundamental change of circumstances could have unacceptable implications for other international treaties concluded by the U.S.S.R. The Board of Directors accordingly exercised its powers of interpretation by deciding that "the limitation on financing and operations that had been requested by the former U.S.S.R. pursuant to Article 8.4 of the Agreement is no longer meaningful and shall not be applicable" to the countries of the former U.S.S.R.[43]

Some member countries continued to fear that the removal of the limitation could result in the allocation of a disproportionate amount of the Bank's resources to the countries of the former U.S.S.R. They did not consider as an adequate safeguard the operating principle of the Agreement that the Bank should not allow a disproportionate amount of its resources to be used for the benefit of any member.[44] In response to these concerns, the Board of Governors approved a policy pursuant to which at least 60 percent of the Bank's resources is to be committed to recipient countries other than the countries of the former U.S.S.R. until the end of 1994. Thereafter, any change would be a general policy decision requiring a two-thirds vote of the Board of Directors.[45]

Dissolution of Yugoslavia

The dissolution of the Socialist Federal Republic of Yugoslavia raised new issues relating to Bank membership. The situation was complicated by the secession of several constituent republics and the region's collapse into civil war. After extensive deliberation, the Bank's governing bodies determined that, as Yugoslavia had been dissolved and no longer existed as a state under international law, it had ceased to be a member. None of the countries resulting from the dissolution would be regarded as sole successor, but each of the constituent republics was eligible to be considered for membership.[46]

The dissolution of Yugoslavia also made it necessary to consider the division of its shareholding in the Bank. Not wanting to prejudge the broader issue of rights to the assets of the dissolved Yugoslavia, the Board of Governors decided that, initially, each country previously forming part of Yugoslavia should, upon accession to membership, be allocated the minimum subscription.[47] Following a definitive reallocation of Yugoslavia's shares, each country would, as a condition of continuing membership, subscribe to such number of additional shares as the Board of Governors might determine. Accordingly, the Bank allocated Slovenia, the first of the former Yugoslav republics admitted to membership, the minimum number of shares upon its admission to membership in October 1992.[48] Croatia fol-

lowed suit, and its membership was approved in January 1993 on the same terms.[49] In light of the controversy over its name, the membership application of the former Yugoslav Republic of Macedonia raised the sensitive question of whether the Bank could admit a state that did not have a universally accepted name. The General Counsel advised that, under principles of public international law, a state need not have an internationally recognized name to be considered for membership in the Bank.[50] In the end, a compromise was reached, and the new state's membership was approved in February 1993 under the provisional name "Former Yugoslav Republic of Macedonia."[51]

Dissolution of Czechoslovakia

In contrast to the former Yugoslavia, the dissolution of Czechoslovakia at the beginning of 1993 led to a relatively smooth and uncontroversial succession, resulting in speedy membership for both the Czech Republic and the Slovak Republic. By the middle of January 1993, the Board of Governors had approved the admission of the two new members; the terms of admission reflecting an agreement between them as to the division of the assets of the former Czech and Slovak Federal Republic.[52]

Private Sector Focus

The development of a strong private sector being one of the fundamental goals of the Bank, the Agreement contains a number of provisions bolstering the Bank's private sector focus. Thus, the intended recipients of Bank financing are defined in terms designed to concentrate the Bank's efforts on the financing of the private sector and on state-owned enterprises in the process of privatization.[53] At the same time, the drafters of the Agreement recognized that, given the small size or even nonexistence of the private sector in the recipient countries, the Bank also should support the public sector in its transition from purely centralized control to demonopolization, decentralization, or privatization and to a competitive business environment. The drafters also recognized that the Bank should assist recipient member countries in implementing structural and economic reforms.[54] Loans also may be made for the reconstruction or development of infrastructure if "necessary for private sector development and the transition to a market-oriented economy."[55]

In their desire not to leave things to chance, the drafters of the Agreement imposed quantitative constraints on state sector operations by requiring that not more than 40 percent of the Bank's resources be committed to the state sector of the recipient countries as a whole during the first two years of the Bank's operations and during each fiscal year there-

after. The same limitation applies to each recipient country over a five-year period.[56] The development of a methodology for the application of these quantitative tests was a drawn-out and sometimes difficult process, resulting in approval by the Board of Directors of the so-called portfolio ratio policy, in which the Board interpreted some key terms not defined in the Agreement.[57]

State and Private Sectors

The term "state sector" is defined broadly in the Agreement to include national and local governments, as well as enterprises "owned or controlled" by them.[58] The term "private sector" is not defined, but the definitions are so structured that any enterprise not falling within the state sector is treated as private sector. Some members considered that an enterprise owned by any state, whether or not the recipient country, should be considered to be a state sector entity. However, as the purpose of these provisions of the Agreement is to limit Bank support for enterprises controlled by the governments of the recipient countries, it was determined that only an enterprise owned or controlled by the government of the recipient country should be deemed to constitute part of the state sector.

There were differences of view as to the import of the terms "ownership" and "control." Some members considered that state ownership of a majority interest in an enterprise necessarily required state sector classification. Others believed that equity ownership should be deemed significant only to the extent that it carried with it the power to control the management and policies of the enterprise. It was ultimately agreed that the portfolio ratio policy should note that, while majority ownership created a presumption of control, there were circumstances in which a minority shareholder could exercise control, as, for example, under contractual arrangements. In practice, in dealing with portfolio ratio classifications, the Board of Directors has accepted private sector classification where effective control is exercised by minority private sector investors, even though majority ownership continues to be retained by the state.

The Agreement also excludes from the state sector a state-owned enterprise that is "implementing a programme to achieve private ownership and control."[59] The portfolio ratio policy, while recognizing that such a determination can be made only on a case-by-case basis, states that it would be appropriate to consider that a privatization program is being implemented if the government has "officially declared its intent to privatize the enterprise . . . within a reasonable time, and is taking appropriate steps to give effect to that intent."[60]

Measurement of Portfolio Ratio

The Agreement defines the portfolio ratio in terms of the total of the Bank's committed loans, guarantees, and equity investments provided to the state sector. Consistent with the Bank's operational usage, the portfolio ratio policy treats funds as committed when the documentation for the financing has been signed and is legally binding. Measurement of the ratio on a global basis was to be made as of April 15, 1993 and December 15, 1993 (the latter date marking the end of the Bank's fiscal year). Thereafter, it is to be measured in respect of each fiscal year as of the end thereof. The ratio in individual recipient countries is to be measured at the end of the first five years of operations.[61]

The Bank did not meet its 60 percent private sector objective at the initial measurement dates. As of April 15, 1993, the private sector ratio was 45 percent, increasing to 56.5 percent at December 31, 1993. Under the conditions in which the Bank operates, it may not achieve a global 60 percent private sector ratio for the 1994 fiscal year. However, it is important to note that, when measured in terms of the number of projects or of the level of disbursements, the scope of the Bank's private sector activities is considerably greater than the ratio based on the volume of commitments suggests. As of December 31, 1993, 74 percent of the total number of projects had been in the private sector, accounting for 89 percent of total disbursements.

There is increasing awareness by member countries that, in view of the vast changes that have occurred since the Agreement was signed on May 29, 1990, it may not be reasonable to expect the Bank to meet the ratio for each of the recipient countries by 1996, the end of the first five years of operations. When it was signed, the Agreement envisaged eight recipient countries, only four of which (Bulgaria, Hungary, Poland, and Romania) now exist in their original form.[62] Of the four other countries, the German Democratic Republic ceased to exist before the Bank began operations, and three (Czechoslovakia, the U.S.S.R., and Yugoslavia) dissolved into a number of smaller countries.[63] These 4 countries have now been replaced by 20 recipient countries, including 12 countries of the former Soviet Union that had been subject to a stringent financing limitation. These developments have had a significant impact on the demand profile for Bank financing. In many of the new recipient countries, the private sector is still small, and there is a great need for financing public sector infrastructure projects and supporting the transition to a market-oriented economy.

An effort to meet the target of committing 60 percent of resources to the private sector in each recipient country could imply a reduction or

slowing down of support for state sector projects. Such a policy would not, however, further the long-term objective of the Bank in countries in an early stage of transition to a market economy. The drafters of the Agreement recognized the close interdependence of private and public sector activities. As noted in the Chairman's Report of the conference at which the Agreement was negotiated, the development of the private sector was necessarily seen as a long-term objective.[64] It was evident that, in order to achieve this objective, considerable efforts would be needed in the public sector so as to achieve conditions conducive to the development of the private sector.

The Agreement does not specify what action the Board of Directors should take if the state sector ratio is exceeded as of any measurement date. The Board has been advised that this is a matter entirely within its discretion, having due regard for the object and purpose of the Agreement. In the circumstances, it would seem consistent with the Agreement to apply the portfolio ratio in a manner that will permit the Bank to continue its support for the public sector in countries in early stages of transition while maintaining the commitment of the Bank to private sector development, with a view to achieving the 60:40 ratio as soon as reasonably possible in countries in more advanced stages of transition.

Relationship with Other International Financial Institutions: The Negative Pledge

The Agreement calls on the Bank to cooperate with other international financial institutions and organizations.[65] This provision reflects the concern of the founders to minimize overlap and duplication of effort between the Bank and those existing institutions that are backed by many of the same countries as the Bank. In the spirit of this provision, the Bank has entered into agreements of cooperation with several international organizations, including the Council of Europe, the Organization for Economic Cooperation and Development, the International Labor Organization, and the United Nations Development Program.[66] As several Asian member countries of the Bank have recently become members of the ADB,[67] a memorandum of understanding has been concluded as a first step toward a flexible allocation of areas of principal responsibility between the two institutions in each of these countries. The Bank also regularly participates in cofinancings with the IBRD and with the International Finance Corporation.[68]

An interesting example of cooperation between the EBRD and the IBRD, in which the legal departments of the two institutions played a significant role, was the resolution of a potential conflict of a legal nature

relating to the IBRD's negative pledge clause.[69] This clause is of particular importance for the World Bank, which is permitted by its charter to make loans only to, or with the guarantee of, a member state and which does not normally seek security for its loans. Instead, it relies on a broad negative pledge covenant of the member state intended "to ensure that no other external debt shall have priority over its loans in the allocation, realization or distribution of foreign exchange held under the control or for the benefit" of the borrower.[70] This covenant applies to the creation of any lien, as security for any external debt, on the "public assets" of the member country. In the current version of the clause, "public assets" are defined to include assets of any "entity owned or controlled by, or operating for the account or benefit of, such member. . . ."[71]

The EBRD, on the other hand, given its private sector focus and its objective of supporting privatization and the transition of state-owned enterprises to a competitive business environment, tries to avoid reliance on state guarantees whenever it can do so, consistent with sound banking principles.[72] The EBRD has therefore sought to develop nonrecourse financing techniques based on various types of security interests. Such credit structures also make it possible for the EBRD to fulfill its catalytic role of attracting cofinancing from commercial banks and export credit agencies, which generally have been reluctant to extend unsecured sovereign credits to many of the countries in which the EBRD operates. In the case of projects of state-owned enterprises and public infrastructure projects, such security arrangements frequently involve the creation of liens on properties or revenues that fall within the definition of "public assets" in the World Bank's negative pledge clause.

This issue was brought into focus when both the World Bank and the EBRD began to prepare for operations in the Russian Federation after it had joined the World Bank in 1992. In addition to cofinancing a World Bank oil sector loan to the Russian Federation, the EBRD wished to complement such sovereign lending with nonrecourse project financings of the oil sector, which remained substantially in the hands of state-owned enterprises. Such project financings typically are secured by a pledge of oil export revenues in an "offshore" debt-service account. In order to permit the EBRD—and the export credit agencies with which it wished to arrange cofinancings—to proceed with such projects, it was necessary to find ways in which conflict with the World Bank's negative pledge could be avoided. Although in the past the World Bank granted waivers in special circumstances, this procedure is cumbersome, as it normally requires case-by-case approval by its Board of Directors.

The modern trend in international financial practice has been to relax the application of negative pledge restrictions, so as to permit the

incurrence of secured debt to finance productive projects. The formulation of a general waiver policy for project financings consistent with that practice appeared to be a desirable course of action for the World Bank, as well as for the EBRD in respect of its public sector loan and guarantee agreements.[73] The elaboration of such a general waiver policy occurred over a period of about 18 months, involving not only consultation between the IBRD, the EBRD, and some of their shareholders, but also with representatives of the Berne Union and the Russian Federation, the country that initially had the greatest interest in reaching an understanding regarding security arrangements for project financings.[74]

There was general agreement on the concept that the waiver should be granted in respect of projects producing incremental foreign exchange earnings. However, the World Bank and the EBRD initially took different approaches to establishing the conditions to be met by the project, and by the country, in order to be eligible for the waiver. The World Bank policy that had been adopted in March 1993 had required, among other things, that the assets subject to the lien be held by a special purpose entity. It had also imposed a number of other specific conditions. Meanwhile, the EBRD in considering its waiver policy had to take into account the EBRD's purpose of assisting its recipient countries to mobilize capital for state-owned enterprises in transition and to maximize the use of project-financing techniques, rather than relying on state guarantees. The EBRD also wished to adopt a waiver policy that would encourage financing, including cofinancing of its projects by export credit agencies and commercial banks, which typically prefer security arrangements to state guarantees.

Accordingly, in November 1993, the EBRD adopted a policy under which the waiver applies generally to liens securing external debt incurred in project financings, provided that there is a reasonable expectation that the debt can be serviced from the revenues generated by the project. If project revenues are paid into an escrow account, the lien may not cover more than 12 months' projected external debt service. Waivers may be granted by the Bank for an initial period of three years, on recommendation of the EBRD President, to a country that is implementing policies furthering the transition to an open, market-oriented economy.[75]

As differences in the negative pledge waiver policies of the World Bank and the EBRD could have led to practical difficulties in countries that are borrowers from both banks, there were continued consultations, following which the World Bank submitted to its Executive Board a proposal more closely aligning the policies of the two institutions. This revised waiver policy was approved by the Board of Directors of the World Bank in December 1993.

Conclusion

In addition to the distinctive features previously mentioned, the EBRD Agreement differs from the charters of other international financial institutions in its level of operational detail. Rules that in other international financial institutions are developed by governing bodies in documents such as regulations, policy papers, and operational guidelines are etched in the founding document of the EBRD. Additional interpretative guidance is provided by the Chairman's Report.[76] Providing explanatory notes to the individual provisions of the Agreement, the Chairman's Report was intended to be read with the Agreement itself. It states that

> certain formulations in the text represented general understandings which needed to be recorded, but which were not suitable for the Articles. It was therefore agreed that . . . [this] report would form part of EBRD's basic documents, for future reference in interpreting the Articles.[77]

There is an obvious conflict between the interests of contracting parties, which wish to influence an organization by regulating extensively its future activities, and those of its governing bodies, which seek optimal freedom of action in managing the course of the institution. In the case of the Bank, one commentator has remarked that a "strong desire not to leave things to chance seems to have taken precedence . . . over considerations of appropriate drafting."[78] Others have predicted that "the detailed provisions of the Agreement, which were inevitably influenced by the exigencies of the time of drafting, may cause difficulties in implementation over time."[79] It is too soon to tell whether the proper balance has been struck. As Sir Joseph Gold stated in his paper on the International Monetary Fund:

> [t]he effectiveness of the legal norms of the Fund depends on the extent to which they are respected by members, and respect for them depends on the extent to which members are convinced that the norms promote their interests. The conviction may emerge that norms are unsatisfactory because they are out of date."[80]

The EBRD's experience with some of the issues that have been touched upon here suggests that, in order to serve its object and purpose, the legal norms of the EBRD must continue to be adapted to the rapidly changing environment in which it operates.

COMMENT

RUSSELL L. MUNK

Introduction

Using the European Bank for Reconstruction and Development (EBRD) by way of example, this comment briefly summarizes how the United States participates in the several development banks. Each country that is a member of a development bank has a Governor. The U.S. Governor for all of the development banks is the Secretary of the Treasury; that is why the U.S. Department of the Treasury is the agency within the U.S. Government that has responsibility for U.S. participation in the development banks.

Each bank has a Board of Executive Directors with responsibility for supervising the day-to-day operations. The EBRD has 23 Executive Directors, 1 of whom is a representative of the United States. Under U.S. law, the U.S. Executive Director is appointed by the President and confirmed by the U.S. Senate.[1] This can create problems because there is often a delay in getting an Executive Director appointed. For example, there was a question of what would happen during the interim between the end of the prior Administration and the appointment of an Executive Director by the current Administration. The Treasury temporarily appointed the Assistant Secretary of the Treasury to be the U.S. Executive Director of the EBRD. In turn, the Executive Director appointed an Alternate Executive Director, who actually functioned in London. Finally, in the spring of 1994, the Senate confirmed an individual as the Executive Director.

Role of the U.S. Treasury Department

Within the Treasury Department, a 16-person Office of Multilateral Development Banks is responsible for following the issues in the development banks on a day-to-day basis. Three persons work on environmental issues, three persons review loan documents, and a couple of people review procurement issues.

Interagency groups within the U.S. Government also monitor the development banks. There is one group for expropriation issues and another for the environment. In these groups, representatives from the State Department, the Environmental Protection Agency, and the

Commerce Department, as well as the Treasury Department, meet and discuss various issues relating to U.S. participation in development banks.

A relatively new phenomenon is the increasing role of the nongovernmental organizations (NGOs), which concern themselves with environmental, resettlement, and population issues. The Treasury Department is careful to consider their views in formulating its policies.

Funding

One of the reasons that the development banks are interested in the United States is their need for financial support. However, the United States has a large budget deficit. The upshot is that the United States is in arrears on its obligations to a number of the development banks. For those involved with U.S. participation in the development banks, this is a source of concern. Every year, the Treasury Department seeks contributions from Congress for the development banks. For several years, however, the Treasury Department has not been able to get congressional authorization for financial support of the EBRD.

One problem with the EBRD is that it is a new institution. Usually, new institutions require more money in their start-up stage. Typically, in a more established institution such as the World Bank or the Inter-American Development Bank, if a country buys stock, most of the stock is callable capital. If the bank is otherwise unable to service its debt, the callable capital acts as sort of a guarantee, and the subscribing country does not have to put cash in the bank up front. However, that is not the case with the EBRD. As a new institution, it did not have loans outstanding. The only way that it could make money was to take cash from the members and invest it, and then operate off the investment. Thus, 30 percent of the EBRD capital is represented by paid-in capital.[2] As a consequence, the Treasury Department has had difficulty mobilizing the amount of funds that the United States owes to the EBRD.

Setting the Agenda

The Treasury Department maintains a continuous dialogue with the EBRD. The United States would always like the development banks to address items on their agendas that they are not currently addressing. At the same time, the United States recognizes that it is not the only member of the development banks. With respect to the Fund for Special Operations at the Inter-American Development Bank, if the United States opposes a loan, it will fail. However, in the other development banks, even if the United States votes no, the loan will still go ahead.

In the EBRD, environmental considerations are built into the charter. In 1989, the U.S. Congress passed a law that is referred to as the "Pelosi Amendment."[3] It requires, among other things, that the U.S Executive Director may not vote in favor of a loan with significant environmental effects unless an assessment has been prepared, and such assessment has been circulated 120 days before the loan goes to that bank's Board of Executive Directors. The EBRD has been unable or unwilling to meet this 120-day requirement. As a result, the United States has voted against a number of EBRD loans. It is noteworthy that, according to the Pelosi Amendment, any loan with a significant effect on the human environment—negative or positive—must be studied. In a number of cases, difficulties arose because, although the loan had a significant positive effect, the EBRD did not prepare the documents 120 days in advance.

Another area where the United States is pressing the EBRD is disclosure of information. The NGOs and members of Congress feel that the development banks have not been open enough and have not consulted affected peoples sufficiently in their operations. This concern has given rise to an effort to make the documents of the development banks more available to the public and to NGOs. The World Bank set up a public information center, and it made arrangements in 1993 for disseminating its documents more widely. The United States believes that this precedent should be followed by the EBRD, as well.

Arising out of its concern for greater protection of the interests of people affected by bank projects, the United States has also been encouraging the EBRD to establish an inspection panel. A few years ago, a project of the World Bank provoked a controversy about resettlement plans.[4] At that time, the World Bank established a commission of experts, headed by Bradford Morse, to look into the matter.[5] The Morse Commission prepared a report that in general concluded that the World Bank had not adequately insisted that the provisions of the loan documents be implemented.[6] The Executive Board of the World Bank took up the issue and determined not to authorize further disbursements for this particular project unless certain reforms were initiated by India. India did not carry out these reforms and decided not to continue to receive funding for the project. Some members of Congress and individuals within the U.S. Executive Branch were impressed by the work of the Morse Commission; they suggested the establishment of a permanent body in the World Bank that would function like the Morse Commission. In September 1992, the World Bank set up an inspection panel consisting of a permanent group of three outside experts to look into complaints regarding the World Bank's implementation of policies and its enforcement of loan covenants. Members of that panel were appointed in the spring of 1994. The EBRD has not yet taken steps to set up such a panel, even though the United

States is pointing to the EBRD's sister institutions, the Inter-American Development Bank and the Asian Development Bank, as examples; these latter institutions seem well along in establishing such panels for themselves.

Concerned about the possibility of waste, fraud, and abuse, the U.S. Congress has encouraged the Treasury Department to exhort the development banks to tighten up their internal auditing and inspection procedures. In turn, the Treasury Department has sought to encourage the EBRD to strengthen the role of its internal auditor.

Finally, there are issues regarding expropriation. A new law mandates that the United States vote against loans to countries in which there are outstanding claims against expropriation by U.S. citizens.[7] However, the law excludes, among other things, expropriations that took place before January 1, 1956. Moreover, the United States does not have to vote against a loan to a country with outstanding expropriation claims if the loan supports basic human needs.[8] The Treasury Department will have to explain this law—and how it will be implemented—to the various development banks.

Conclusion

The United States is very supportive of the important role that is played by the development banks. At the same time, the U.S Congress and the public have expressed an active interest in this role. Laws have introduced new requirements concerning U.S. participation in the development banks. The Treasury Department will continue to explain and interpret these requirements, and otherwise oversee U.S. participation in the banks.

Chapter

5 European Monetary Union and the European System of Central Banks

CYNTHIA C. LICHTENSTEIN[1]

Introduction

On November 1, 1993, the Treaty on the European Union signed at Maastricht on February 7, 1992 (the Maastricht Treaty) came into force.[2] Despite the difficulties in the summer of 1993 with the European Community's system for holding most of its member states' currencies in close alignment,[3]—the exchange rate mechanism—the European Union followed the provisions in the Treaty for the progressive stages of economic and monetary union. The Union took the steps provided for at the second stage (to begin January 1, 1994), namely, the creation of the European Monetary Institute (EMI).[4] The European Council, meeting in Brussels on December 10–11, 1993, having previously decided that the EMI would have its seat in Frankfurt, appointed (in accordance with the procedures set out in Article 109f of the Treaty) Professor Baron Lamfalussy, former General Manager of the Bank for International Settlements, as the President of the EMI. It is the function of the EMI, among others laid out in Article 109f of the Treaty, to prepare for the third stage of Economic and Monetary Union (EMU).[5]

This chapter addresses the subject of what the EMI is not, and what, as a matter of Community law, it cannot do and cannot impose on the central banks of the member states. It then examines the nature of the European System of Central Banks (ESCB), which is scheduled to come into being at the third stage of EMU (under the Treaty, by January 1, 1999 at the latest).[6] The central thesis of this paper is that, at that point, there will, in fact, be a Union central bank, a Community organ with "lawmaking" powers and access to the Court of Justice to enforce its law. The national central banks will, in effect, be its branches. To demonstrate this thesis, it will be necessary first to discuss briefly Community lawmaking structure and enforcement. The chapter will then discuss how the Treaty on European Union fits the ESCB into this structure as the Union's independent central bank for monetary policy. It will then discuss how this absolute and unitary control over monetary policy does not pertain to the other role of many central banks: prudential supervision. Finally, the chapter addresses how the Treaty deals with the situation in

which the third stage of EMU might begin for some member states but not for others, as well as the special provisions for Denmark and, if the United Kingdom does utilize its "opt-out" clause, the United Kingdom.

Lawmaking Capacity of the Community

It is not possible here to do more than skim the surface of European Union institutions and their lawmaking capacity in order to lay the foundation for understanding what will be the force of the instructions of the European Central Bank (ECB) to the national central banks (which together compose the ESCB) after the effectuation of EMU. A Community organ, such as the Commission or the Council, is given by the Treaty certain competencies, and those organs act (within the competencies) by making regulations, directives, decisions, recommendations, and opinions.[7] Recommendations and opinions do not create law, in the sense that they do not create, under Community jurisprudence, rights of action in anyone. The other acts may be enforced, that is, they entitle persons, institutions, or enterprises affected or granted rights or obligations to go to the European Court of Justice (ECJ) for a judgment. The ECJ over the years has created through the development of certain concepts an overarching Community law that is superior to national law and to which the member states and their national organs are subject. Thus, the House of Lords of the United Kingdom has declared that the Parliament knew when it entered into the Community that it was accepting the Community rule of law and that, therefore, an Act of Parliament violating Community law could not stand.[8]

Even before the Treaty on European Union came into force, the Treaty of Rome, as amended by the Single European Act (to try to achieve the single market), had included a series of articles providing for Community legal control over Community law in accordance with the dictates of the Community organs under the Treaty. The ECJ has the power of judicial review over the question of whether the Treaty has been followed when the Community organs act.[9] Moreover, several provisions of the Treaty provide for enforcement of Community law. Article 169 gives the Commission (the Community "executive") oversight over whether a member state is fulfilling its obligations under the Treaty or under Community secondary legislation.[10] The Commission must give the state concerned the opportunity to present its side of the matter and then issue a "reasoned opinion" on why it thinks the state is failing to comply with Community law. The Commission may take the matter to the ECJ if the member state does not comply with the opinion. Article 171 provides that, if the ECJ finds that a member state has failed to fulfill an obligation under the Treaty, the state "shall be required to take the necessary

measures to comply with the judgment of the Court of Justice."[11] Paragraph 2 as added by the Maastricht Treaty provides a procedure for the Commission to review whether a member state has complied with a judgment and to go back to the ECJ if necessary to ask for a penalty payment.[12] Article 173 provides the ECJ jurisdiction to review the "acts" of Community organizations, "other than recommendations and opinions," at the instance not only of other organizations, but also of member states, and Article 175 relates to suits for failure to act.[13] Article 176 provides an obligation upon a Community institution that has acted or failed to act comparable to the obligation upon member states in Article 171.[14] Article 177, a frequently discussed provision in treatises on Community law, is the requirement that national courts refer up to the ECJ for "preliminary rulings" issues in their courts that implicate Community law.[15] This provision of the Treaty ensures not only that Community law is supreme, but also that national courts do not give rise to divergent national views of what the Treaty means. Article 177 is a powerful weapon for creating a jurisprudential union, for ensuring that treaty interpretation and interpretation of "acts of the institutions of the Community" (that is, Community secondary legislation) are not considered to be political questions that are not subject to the Community legal order.[16] Article 177 means not only that the Commission is a watchdog through its powers under Article 169, but also that a private party in a national court can claim that the matter before that court requires an ECJ preliminary ruling, and so have the ECJ rule on what the Community law's view of the matter should be.[17]

The Treaty on European Union provided for the integration of a single central bank, a single monetary policy, and a single currency into the Community's far-reaching system of jurisprudence. Arguably, if one understands the effect of establishing the ECB as a Community institution under these provisions, one understands why the United Kingdom demanded, as the price of its signature on Maastricht, an opt-out clause exempting it from the third stage of EMU at its option, (even if ultimately the United Kingdom does not exercise this option).

"Delicate" Task of the EMI

The second stage of EMU began on January 1, 1994, and, pursuant to it, the EMI came into existence. Professor Jean-Victor Louis has stated that "there is no transfer of power in the field of monetary policy during the second stage. The EMI Council cannot take monetary policy decisions, such as fixing interest rates or decreeing compulsory reserves."[18] The EMI is assigned many important tasks by the Treaty, not the least of

which is to prepare for the third stage by specifying the "regulatory, organisational and logistical framework necessary" for the new monetary institution of the third stage, the ESCB, "to perform its tasks in the third stage."[19] However, as Professor Louis has noted, its role is "delicate because it has a power of influence more than a legal power of decision in a period in which Member States retain their competences in the field of monetary policy."[20] Thus, while Article 109f provides that during the second stage the EMI shall have all the power given to the ECB by the Maastricht amendments to the Articles relating to judicial control,[21] the EMI's lack of power of decision over monetary policy means that the power to enforce, the power to go to the ECJ, is meaningless in that respect.

The power under Article 173 (of going to the Court "for the purpose of protecting [its] prerogatives") might be useful to force the Council of the Community to "consult" the EMI "regarding any proposed Community act within its field of competence" or to force the authorities of the member states to consult it on "any draft legislative provision within its field of competence."[22] But what is the EMI's "field of competence"? Its tasks are set out in Article 109f: to "strengthen," "monitor," "hold consultations," "facilitate," "prepare," "promote," and "supervise."[23] The last task suggests some power in the meaning of "competence." The EMI is to supervise "the technical preparation of ECU banknotes."[24] Under the EMI's Statute, made part of the Treaty by a Protocol, the EMI may perform the "legal acts" of delivering opinions and making recommendations and may "adopt guidelines, and take decisions, which shall be addressed to the national central banks."[25] Only "decisions" are "binding," and then only "upon those to whom they are addressed."[26] Article 15.4 also refers back "[w]ithout prejudice to Article 3.1," which provides that the EMI shall act "without prejudice to the responsibility of the competent authorities for the conduct of monetary policy within the respective Member States."[27]

Sea Change of the Third Stage

The lack of power to enforce through judicial access of the EMI in the move to monetary union contrasts with the powers of the ECB in the third stage. The Treaty provides for the beginning of the third stage if a requisite number of member states fulfill "the necessary conditions for the adoption of a single currency."[28] It mandates January 1, 1999 as the latest date for attainment of the third stage and presumes that, before that date at the latest, the EMI will have vanished and the ECB and the ESCB have come into being, with the tasks and powers set out in the Treaty and the Protocol on the Statute of the European System of Central Banks and

of the European Central Bank annexed to the Treaty.[29] This Statute's title contains references to both the ESCB and the ECB, and Article 1, Chapter I of the Constitution of the ESCB says that the two "shall be established in accordance with Article 4a of this Treaty," which says no more than that they shall be established.[30] It is necessary to turn to Articles 105 and 106 of the Treaty to ascertain the tasks and the legal structure of the ECB and the ESCB. The first task cited is "to define and implement the monetary policy of the Community."[31] The second task is "to conduct foreign exchange operations" as authorized by the Council under Article 109. The third task is "to hold and manage the official foreign reserves of the member states." The fourth is "to promote the smooth operation of payment systems."[32] Article 105(5) and (6) relate to the role of the ECB and the ESCB with respect to "prudential supervision of credit institutions and other financial institutions," which is discussed subsequently in this chapter.[33] Article 105a gives the exclusive right to authorize the issuance of banknotes to the ECB, although the actual issuance may be by both the ECB and the national central banks.[34]

In the performance of these tasks, what is the relationship between the ECB and the national central banks? In carrying out these tasks, which of the two is given the lawmaking powers? The Treaty is very clear. The ESCB consists of the ECB and the national central banks, but the two are hardly in a relationship of equality. "The ESCB shall be governed by the decision-making bodies of the ECB which shall be the Governing Council and the Executive Board."[35] Article 8 of the Statute of the ESCB sets out the same phrase, namely, "[t]he ESCB shall be governed by the decision-making bodies of the ECB," as the "General Principle."[36] Article 9.2 of the Statute states unequivocally that the ECB "shall ensure" that these tasks "are implemented either by its own activities pursuant to this statute or through the national central banks pursuant to Articles 12.1 and 14."[37] Article 14.3 states that the national central banks "shall act in accordance with the guidelines and instructions of the ECB."[38] The section then requires the Governing Council of the ECB to "take the necessary steps to ensure compliance with the guidelines and instructions of the ECB. . . ." This is a clear reference to the power of the ECB under Article 180 of the Treaty to take a national central bank to the ECJ if that bank does not comply with a reasoned opinion explaining why it is in violation of the ECB's guidelines or instructions.[39]

However, it is not only in relation to the national central banks that the ECB has been given the power to resort to the ECJ to enforce its mandate of directing the Union's single monetary policy in the third stage. Recall that, under Article 173 as amended by the Maastricht Treaty, the ECB may resort to the ECJ "to protect [its] prerogatives."[40]

Under the Treaty, economic policy is coordinated by the Council while the ECB has exclusive control of monetary policy. The Treaty contains provisions for participation of the President of the Council and a member of the Commission in meetings of the Governing Council of the ECB, and for participation of the President of the ECB in Council meetings "when the Council is discussing matters relating to the objectives and tasks of the ESCB."[41] Suppose that the Council and the ECB differ as to whether the Council is discussing such a matter, and the Council fails to invite the President of the ECB to its deliberations. (In the United States, by way of analogy, such a matter might be held to be a political question on which the federal courts would not intervene.) There is no question that under Article 173 the ECB would have the right to ask the ECJ for a ruling on the question of whether the matter under discussion by the Council related to the ESCB and to obtain a judgment against the Council, ordering it to permit the President of the ECB to be present.[42]

Role of the ESCB in Prudential Supervision

Unlike its control over monetary policy, the ECB has only a limited role to play in the area of prudential supervision.[43] This conclusion assumes the absence of Council action (which must be taken unanimously on a proposal from the Commission and after ECB consultation and assent from the European Parliament) under Article 105(6) to "confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings." Article 105 of the Treaty provides that the ESCB "shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."[44] Just how this contribution is to be made is not spelled out in the Treaty. Thus, the scheme of prudential supervision remains within the jurisdiction of the national central banks or other national authorities. However, it will be recalled that Article 105(4) requires consultation of the ECB both on any proposed Community act "in its fields of competence" and by national authorities as to draft legislation, again within its fields of competence.[45] Here, the Council of the Community is to set the limits and conditions of the consultation.[46] Thus, if the Community were to enact legislation providing for prudential supervision of participation in the derivatives markets, the ECB would have to be "consulted." Moreover, these provisions will give the ECB some limited input into national legislation on supervision of the financial markets. However limited the role, the fact remains that, if either the other Community organizations or a

member state were to ignore the ECB in policing the markets and the actors in the markets, the ECB could request the Court to order it to be "consulted." The judicial control mechanism gives more force to a vague prerogative.

ESCB in a Bifurcated Currency Union

Up to this point, the discussion has proceeded as if all the member states would, by the agreed final date for the third stage of EMU, give up their own system of monetary policy, adopt the single currency (the ECU or rather, as this goes to press, the euro), and be subject, as far as monetary policy is concerned, to the control of the ECB. However, the Maastricht Treaty recognizes that, in fact, not all the member states will necessarily meet the criteria for entrance into the single currency union; it also provides in separate protocols that Denmark and the United Kingdom need not participate in the third stage.[47] How then will the ESCB operate in this eventuality? Article 109k of the Treaty provides for the situation, as does Chapter IX of the Statute of the ESCB.[48] Those states (as well as Denmark and the United Kingdom if they so choose) that do not fulfill the conditions for the adoption of a single currency are called by the Treaty "Member States with a derogation."[49]

Those states so designated are not subject to the rights over their monetary policy (and consultation obligations on their prudential supervision legislation) given the ECB in Articles 105 and 105a, the lawmaking authority of the ECB given in Article 108a, or the Community's power over their foreign exchange policies given in Article 109.[50] (The derogation also applies to other economic policy obligations.) A member state with a derogation does not participate in naming the members of the ECB's Executive Board.[51] This general scheme of nonapplicability of certain ESCB rights and obligations is set forth in Chapter IX of the Statute of the ESCB and the ECB, which specifies that the central banks of states with a derogation "retain their powers in the field of monetary policy according to national law."[52] Therefore, they are not subject to the instructions of the ECB noted previously. Article 43.4 lists specifically those Articles of the Statute that shall be read as applying only to national central banks without derogation. However, other activities and tasks of the ESCB (such as collection of statistical information and reporting activities) do not involve the authority of the ECB over the national central banks but involve only collaborative functions. To ensure that this collaboration is carried out at the level of the ECB, the Statute provides for establishment of a third decision-making body (the first two being the Executive Board and the Governing Council), the General Council, whose responsibilities are set out in Article 47 of the Statute.[53]

The main point is that in a bifurcated monetary union the governors of the central banks in the single currency sit on the Governing Council of the ECB; the governors of the central banks whose member states have a derogation sit on the General Council with the other governors. If one remembers that it is the Governing Council of the ECB that controls the ECB's right of access to the judicial control mechanisms, the division of authority between the two decision-making bodies is clear.

COMMENT

ROSA MARIA LASTRA

European Monetary Union and Central Bank Independence

Introduction

This comment focuses on three issues: the process leading toward the creation of the European System of Central Banks (ESCB) in the third stage of Economic and Monetary Union (EMU); the steps already taken in implementing the Treaty on European Union (the Maastricht Treaty); and central bank independence. The first two issues, relating to EMU and Maastricht, are of particular interest for Europeans. The third one, crucial at the level of the European Union (EU), also is a key issue for other nations in the developed world and for developing countries.

Process Leading Toward the Creation of the ESCB in the Third Stage of EMU

The history of monetary integration in the European Community (EC), as well as the very history of the EC, shows how an organization gains and loses momentum in its gradual development and how the political will to move forward is at least as important as the economic benefits derived from the integration. Since its inception, the EC has been confronted with various challenges: the Customs Union in the late 1950s and 1960s; the consolidation of its institutions and the first enlargement in the 1970s; the single European market program and the second enlargement in the 1980s; and the deepening (not only in terms of economic union, but also of monetary and even political union) and prospective further enlargement of the organization in the 1990s. Additionally, the EC faces other problems today, including the alleged lack of democratic legitimacy of its institutions and the need for institutional reform, its increasing bureaucratization, the need to define more clearly the requirements of the principle of subsidiarity, and the existence of regional economic imbalances.

Although the Treaty partially addresses the challenges of the 1990s, it fails to solve adequately some of the concerns of member states and prospective applicants. There are also constitutional constraints on the realization of the goals agreed in Maastricht. The European Union is not a federation. Neither the Maastricht Treaty nor the founding treaties of

the European Communities provide a formal "constitution" to the Union. Moreover, the nonexclusive transfer of sovereign powers from the member states to the EU institutions in the third stage of EMU will result in a dual responsibility divided between EU institutions and national authorities.

It should be noted that the Maastricht Treaty is a rather complex legal document. Amendments to the Treaty Establishing the European Economic Community, which pertain, inter alia, to monetary union, comprise Article G of the Maastricht Treaty.[1] The European Union is formed of the three existing European Communities, namely, the European Coal and Steel Community, the European Economic Community (now the EC) and the European Atomic Energy Community.[2] The EU is supplemented by two forms of cooperation established by the Maastricht Treaty, the common foreign and security policy and the cooperation in the areas of justice and home affairs.[3]

While the Single European Act captured the momentum gained in launching the internal market program as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured"[4] and prepared the way for further monetary cooperation, the Maastricht Treaty tried to capitalize on the momentum gained on the road toward EMU.[5] However, its drafting, signature, ratification, and implementation provide a good example of the ups and downs of the history of EC integration. The Treaty finally came into force on November 1, 1993, opening the way for the future establishment of the ESCB. Its forerunner, the European Monetary Institute (EMI), started operations in January 1994, at the start of the second stage of EMU. The EMI is conceived as a transitional and preparatory phase for entry into the third stage. It is a rather weak institution, whose operations seem to show a continuity with the Committee of Central Bank Governors that it replaced, rather than a substantial new approach to the realization of EMU.[6] More monetary stability seems to be necessary in order to move ahead with the EMU plan, and, as the member states retain their monetary policy responsibilities in the second stage, it is uncertain whether the EMI has the powers to achieve its goal.[7]

Paradoxically, the Maastricht Treaty gained binding legal force at a time when some member states were more preoccupied with their growth prospects and unemployment problems than with the pursuit of price stability. The economic slowdown in many European countries at the beginning of the 1990s and the historical events that have changed the shape of Europe in the past several years, namely, German reunification, the breakup of the former Soviet Union, the transition in Eastern Europe and the Baltic countries, Russia, and the other countries of the

former Soviet Union from centrally planned economies to market economies, and the breakup and war in Yugoslavia, have signified a change of priorities in the European continent.

Arguably, European citizens and their expectations have lost touch with the supranational objectives agreed in Maastricht. This criticism was evidenced during the period of ratification of the Maastricht Treaty. The Danish and French referendums, the British opposition to the Treaty, the legal challenges presented to the German Federal Constitutional Court,[8] the rise of popular opinion in Germany against the prospective disappearance of the deutsche mark, and the general disenchantment across Europe with a community perceived as distant from its citizens were some of the difficulties that member states faced in that period.

Following the September 1992 currency crisis and the speculative movements in the ensuing months, the exchange rate mechanism (ERM) of the European Monetary System (EMS) was reformed in August 1993. The widening of the bilateral bands to plus or minus 15 percent (except for the bilateral relationship between the deutsche mark and the guilder, to which the previous 2.25 percent band still applies) has been characterized by some economists as a virtual breakdown of the system.[9]

As regards the future of the ERM, there are in theory several options[10] besides the present status quo: reintroduction of exchange controls; accelerated movement toward EMU in a subset of core countries; the taking of alternative routes to EMU; and reversion to narrow bands. The last option seems to have been rejected as an official solution by the ministers of finance of the member states and by the President of the EMI because it would require a credible commitment to intervene to defend a currency that exceeds those bands (that is, a commitment made by the central bank of the strongest currency to support the weak currency).[11] Unofficially, however, some member states, such as Belgium, the Netherlands, Luxembourg, Denmark, and Ireland, have been trying to operate within a fuzzy 2.25 percent narrow band, and the ERM has been relatively stable since its reformation.

The "convergence criteria" that member states must meet to qualify for monetary union, defined in Article 109j and further elaborated in a Protocol annexed to the Treaty, refer to price stability, nonexcessive government budgetary deficits, stability within the ERM, and (reflecting the durability of the convergence achieved under the ERM) stable, long-term interest rate levels.[12] The EU is due to hold an Intergovernmental Conference in 1996 to revise the Treaty as far as seems desirable in the light of experience.[13]

According to the letter of the law, stability within the ERM (one of the four criteria of economic convergence) can be understood as stability within the wide bands and, therefore, can be managed in the context of Article 109j. However, the spirit of the law when the Treaty was signed in Maastricht in February 1992 was different.

The main problem ahead in achieving economic convergence lies in the size of government deficits, as most of the member states, including Germany, would not pass today the test of having a "sustainable government financial position," strictly read. However, the language of Article 104c of the Maastricht Treaty, in combination with the Protocol on Excessive Deficit Procedure annexed to the Treaty, provides some room for interpretation: the sustainability of the government financial position is defined, first, by "whether the ratio of planned or actual government deficit to gross domestic product exceeds the reference value [3 percent], unless either the ratio has declined substantially and continuously and reached a level that comes close to [3 percent] or, alternatively, the excess . . . is only exceptional and temporary," and, second, by "whether the ratio of government debt to gross domestic product exceeds a reference value [60 percent], unless the ratio is sufficiently diminishing and approaching [60 percent] at a satisfactory pace."[14] Therefore, a country (for example, Ireland) whose public debt-to-GDP ratio considerably exceeds the 60 percent reference value, would still be able to qualify for EMU if the debt ratio is considered to be "sufficiently diminishing" at a "satisfactory pace."[15] The Council of Ministers will decide whether an excessive deficit exists or not, acting on a recommendation from the European Commission.[16]

The criteria of economic convergence have been regarded by Germany as a condition sine qua non in order to move ahead with EMU. The ruling of the German Federal Constitutional Court of October 12, 1993 clearly reaffirmed that "the convergence criteria cannot be relaxed. . . . [T]he Federal Republic of Germany, by ratifying the Union Treaty, is not subjecting itself to unsupervisable, unsteerable, automatic pilot in its progress to a monetary union."[17] The wording of the German Federal Constitutional Court's ruling is consistent with previous and subsequent declarations of the Bundesbank:

> The key to further advance in monetary integration is a ***sufficient degree of convergence*** in economic development and economic policy between the member countries of the union. . . . [T]he Treaty stipulates that the European economic and monetary union shall enter its third stage on January 1, 1999. However, even then ***only those countries that meet the convergence criteria can participate.***[18]

The skepticism reigning in the debate about Maastricht will probably pose difficulties in fulfilling the EMU timetable. According to Article 109j of the Maastricht Treaty, not later than December 31, 1996, the Council of Ministers, meeting in the composition of heads of state or government and "[t]aking due account"[19] of the reports prepared by the European Commission and the EMI on the progress made by member states regarding these convergence criteria, and of the opinion of the European Parliament, shall decide, acting by a qualified majority, whether a majority of the member states fulfill the necessary conditions for the adoption of a single currency (that is, the convergence criteria) and whether it is appropriate for the Community to enter the third stage. If so, the Council of Ministers will set the date for the beginning of the third stage of EMU. If, by the end of 1997, the date for beginning the third stage has not been set, that stage shall start on January 1, 1999.[20] Despite this Treaty provision, the ruling of the German Federal Constitutional Court firmly declared:

> In the framework of the conditional nature of the content of the Treaty and the factual convergences it presupposes, the time for the commencement of the third stage of economic and monetary union must also be seen as a *target* rather than as a legally enforceable date.[21]

Any change in the EMU provisions made in the 1996 Intergovernmental Conference (because a revision of the timetable for EMU is in fact a revision of the Treaty) would probably open a "Pandora's box" of questions, and a new ratification "by all the member states in accordance with their respective constitutional requirements" would probably mean years of discussion.[22] The Maastricht Treaty represents a compromise between those who favor a federal Europe and those who oppose it. The ambiguity in many of its provisions is rooted in this difficult balance. Should the provisions on monetary union be revised in the 1996 Intergovernmental Conference, EMU may be postponed *sine die*. Seemingly, the only way to go ahead is thus to respect the principle *pacta sunt servanda*, perhaps by creatively reinterpreting the language in the Treaty pertaining to EMU. A consolidation of the incipient economic recovery in Europe may rekindle enthusiasm for EU integration and should help governments streamline their budget deficits, hence facilitating compliance with the Maastricht requirements.

The real challenge for the 1996 Intergovernmental Conference lies in the institutional reform of the European Union, particularly the future structure of the European Parliament, which will have to accommodate both the needs of a Community of 16 or more members and the new responsibilities entrusted to it in the monetary—and eventually the political—area. The roles of the Parliament, the European Commission, and

the Council of Ministers need to be redefined, as well as the representation and voting powers of the states. Moreover, with a free flow of capital, a new policy on the fiscal means of the Community must be adopted. Together with the debate about the deepening of the institutions of the European Union, the debate about its widening is generating much controversy.[23]

Steps Already Taken in Implementing the Maastricht Treaty

The implementation of the requirements imposed by the Maastricht Treaty is on course, both at the level of the member states and at the level of the EU institutions. As regards the latter, some regulations came into force on January 1, 1994. Two of them specify definitions for applying the prohibitions contained in Articles 104 and 104a of the Treaty, which refer respectively to the prohibition of the financing of government deficits through central bank credit and to the prohibition of privileged access by public authorities to financial institutions.[24] Another regulation on the application of the controversial Protocol on Excessive Deficit Procedure requires member states to report to the European Commission their planned and actual government deficits and levels of government debt twice a year.[25] The procedure for avoiding excessive deficits is triggered whenever one of the reference values (the 3 percent ratio of government deficit to GDP or the 60 percent ratio of public debt to GDP) is exceeded or threatens to be exceeded.[26]

Furthermore, the Council of Ministers has made some decisions on the functioning of the EMI. One of them refers to the calculation, in terms of population and GDP at market prices, of the member states' contributions to the financial resources of the EMI.[27] Another important Council of Ministers decision refers to the consultation of the EMI by the member states on draft legislation related, inter alia, to currency legislation, status and powers of national central banks, clearing and payments systems, and rules applicable to financial institutions.[28]

At the level of the member states, some of them, such as Italy, France, and Belgium, already introduced legislation in compliance with the Maastricht requirements in 1993.[29] Spain and Germany introduced legislation in 1994, and Greece is expected to enact its legislative proposals soon.[30] The Bank of Spain Autonomy Law was finally enacted in June 1994, following a period of amendments to address some of the concerns posed by the corruption charges faced by a former governor of the Bank of Spain.[31] In Germany, the Bundesbank Act was amended in July 1994, in order to comply with Article 104 of the Maastricht Treaty and the regulation implementing it.[32] In particular, the authorization contained in

Section 20.1 of the Bundesbank Act, which permitted the Bundesbank to grant short-term cash advances to the Federal and Länder Governments, has been revoked.[33] In connection with the ban on cash advances, Section 17 of the Act, requiring public authorities to deposit their liquid resources with the Bundesbank, has also been repealed.[34] The United Kingdom, whose central bank celebrated its tercentenary in 1994, is considering the idea of central bank independence without necessarily linking it to compliance with the Maastricht requirements.[35] Two recent reports encouraging greater independence for the Bank of England, the so-called Roll Report and a report prepared by the House of Commons Treasury and Civil Service Select Committee, have not given rise to any legislative changes so far.[36]

Central Bank Independence

Central banks in Europe and in other parts of the world are experiencing a wave of change toward greater independence. It has become more widely accepted that the central bank should be committed to price stability and that, in order to control inflation, the central bank should be independent from political interference. The following paragraphs point out a few controversial points in the debate about independence.[37]

Central Bank Independence as a Political Decision

Despite the economic merits of central bank independence, the actual decision to grant independence is a political one. Relations between central banks and governments are not always easy; the link between economics and politics is a difficult and complex one, which changes across countries and over time. This is true both for European countries and other developed nations and also for the developing world.[38]

Three Dimensions of Independence

Central bank independence has three dimensions: an institutional or organic one; a functional or operational one; and a professional one. The first two dimensions require the protection of a binding legal framework. The third dimension is often part of the de facto independence, which is determined by the personalities of the governor and minister of finance (and in some cases of other high officials); by the frequency of change of the governor; by the actual practices of both the minister of finance and the central bank; by the depth and quality of economic and monetary analysis; by the political and economic circumstances (for example, eco-

nomic expansion or recession); by the experiences of the country concerned; and by national priorities.

The Maastricht Treaty does provide a legal framework to protect central bank independence; the most significant provision is the prohibition against financing government deficits through central bank credit.[39]

Need for Accountability

Independence is only one side of the coin. The other side in a democratic state is accountability. Such accountability should be "diversified," including through both parliamentary control and accountability to judicial bodies. Disclosure is another form of accountability, generally supported by countries, such as the United States or the United Kingdom, that encourage strong financial market discipline and transparency.[40] Germany, whose model of corporate governance fosters close ties between banks and corporations, with a corresponding flow of confidential information, may not possess an equally strong tradition of disclosure.

Importance of Price Stability Vis-à-Vis Other Economic Goals

Central bank independence is often regarded as a basic premise for a monetary policy committed to monetary stability. Therefore, central bank independence may seem more attractive when a country is concerned about inflation than when a country is trying to fight recession and unemployment. For instance, the Bundesbank's policy of high interest rates in the aftermath of German reunification was questioned in the rest of Europe, which was suffering from an economic slowdown, and even by some in Germany itself. The Bundesbank kept interest rates high in order to fulfill its legal mandate of safeguarding the value of the currency.[41] This commitment to price stability is the essence of the case for central bank independence. It should be noted, however, that the ESCB will be committed to European price stability and not only to German price stability, and that, therefore, it will take into account the interests of all the member states of the Union.

Central Bank Independence and Foreign Exchange Policy

The conduct of foreign exchange policy involves determining the exchange rate and the exchange regime (or exchange arrangement) and managing the official monetary reserves. Responsibility for the formulation of the exchange rate policy typically rests with the government, while responsibility for its implementation is generally entrusted to the central bank. Central banks normally have more freedom to formulate monetary

policy than they do exchange rate policy.[42] However, the Swedish Riksbank is responsible for the determination and implementation of foreign exchange policy, according to Article 4 of the Swedish Central Bank Act.[43]

The government's responsibility in formulating foreign exchange policy is rooted in historical and political reasons,[44] and in the consideration that the exchange rate is not only a nominal anchor for the domestic price level, but also a part of general economic policy, linked to the trade and employment objectives of a country.[45]

The Maastricht Treaty does not entrust the ESCB with clear responsibilities in the field of foreign exchange policy.[46]

Central Bank Independence and Banking Supervision

Independence is often advocated as regards monetary policy. It is also necessary in the conduct of banking supervision. Independence to pursue stable money should thus be accompanied by independence to pursue sound banking. If the central bank is not directly in charge of bank regulatory activities, the bank regulatory agency also needs to be independent from governmental guidelines.

According to the Maastricht Treaty, the national central banks or other competent authorities will keep their supervisory responsibilities.[47]

Independence Alone Does Not Guarantee Price Stability

Other factors need to be taken into account in order to make independence effective in terms of inflation control: fiscal restraint and a credible general economic policy; labor market discipline; the support of the financial and nonfinancial community for anti-inflationary measures; and the political stability of the country.

Chapter

6 The European Community's Second Banking Directive

RENÉ SMITS

Introduction

Before addressing the Second Banking Directive, the major piece of legislation in the field of banking supervision of the European Community (EC), this chapter begins with some introductory statements on the EC and its legislative process. This introduction may help to put the Second Banking Directive into perspective.

Three European Communities

The European Union, as the major organization for European economic and political integration is now called, is the current "end result" of a process of "nation building" that started after the Second World War. At that time, German and French coal and steel production was placed under a common authority, the present-day European Commission. Its functioning, as well as that of the other institutions of the European Coal and Steel Community (ECSC), was laid down in the Treaty of Paris, which entered into force in 1951.[1] A common regime for the market in the two products that had been at the center of the war industry was considered to bring to an end the internecine warfare that had plagued the continent for so long and had twice set afire the entire world. Italy as well the three Benelux states (Belgium, the Netherlands, and Luxembourg) joined France and Germany in the ECSC.

In 1957, the Treaty Establishing the European Economic Community (the EEC Treaty; after Maastricht, the EC Treaty) built upon that first construction for European unity.[2] (The Treaty Establishing the European Atomic Energy Community (Euratom) became operative at the same time but has remained far less important.)[3] The EEC Treaty provided for the establishment, within predefined time limits, of a customs union and a common market among "the Six," as the members were called. They were joined by the United Kingdom, Ireland, and Denmark in 1973 to form "the Nine," by Greece in 1981 (making ten members), while Spain and Portugal joined the EC (as the three Communities were then commonly named) in 1986. Currently, applications for membership are pend-

ing from Turkey, Malta, Cyprus, Hungary, and Poland. A request for accession from Switzerland is dormant; the Swiss voted down participation in the internal market through the European Economic Area, so full accession is not on the table. The accession of Finland, Austria, Sweden, and Norway was negotiated and ratified by the European Parliament; in Finland, Austria, and Sweden, the popular vote was affirmative, but the Norwegians voted against membership.

Customs Union and Common Market

The establishment of a customs union and a common market was meant to be brought about through decisions that the Council of Ministers (the body consisting of ministers from the member states) would take on proposals from the European Commission (the Community's executive arm, consisting, at present, of 17 men and women who operate independently of government instructions and who are accountable to the European Parliament). The European Parliament was to give its opinion on draft legislation. A European Court of Justice was established in Luxembourg to ensure that the law was observed. Although many measures tearing down restrictions and abolishing discriminations between the member states were in effect taken, the major impetus toward integration came from the European Court of Justice. It held that citizens and companies could rely on the directly effective provisions of the EEC Treaty and of secondary law (that is, legislation adopted under the EEC Treaty). This ruling promoted the freedom of movement for economically active people, goods, services, and capital that the EEC Treaty meant to bring about.

1992 Internal Market Program

Nevertheless, the vision of an economically integrated Europe needed further positive action to be completed: too many national laws made the operation of business across state boundaries a difficult and expensive affair. Diverging labeling laws, local authorization requirements, a lack of recognition of diplomas and certificates, the incidence of tax laws, and the dispersal of supervisory authority among 12 jurisdictions made "Europe" nonexistent in many economic areas. To remedy this situation, an enormous legislative program was started, under which the Council was to adopt in cooperation with the European Parliament directives harmonizing many economic laws and eradicating the last obstacles to an integrated market. The Single European Act, adopted for this purpose, contained important amendments to the EEC Treaty.[4] It provided that the internal market was to be completed before the end of 1992.

Maastricht Treaty: Political Union and Economic and Monetary Union

The vision of a politically integrated Europe that lay at the root of economic integration (which had been adopted once a direct road to a political and defense Community had been cut off in the early 1950s) gained momentum with the end of the cold war and the collapse of the Soviet Union. The time seemed ripe for a new leap toward common external policies beyond the field of international trade. Also, the commitment to abolish the internal Community borders necessitated further cooperation in the areas of justice and home affairs. Thus, a conference was called to draft the necessary provisions.

A parallel conference was to crown the internal market with the establishment of Economic and Monetary Union (EMU), that is, common economic policies and a single currency for Europe.

The end result of this bargaining process is the Maastricht Treaty on European Union.[5] It establishes two pillars of intergovernmental cooperation (in external and defense matters, as well as for justice and home affairs) next to the Community pillar, whose legal foundations were expanded and modernized, with a specific timetable set for establishing EMU and delegating additional powers to the European Parliament. The ensemble was labeled the "European Union." Although this name does not indicate a new international legal person, it gained acceptance once the difficult process of ratifying the Treaty on European Union had been completed. The Treaty on European Union encompasses amendments to the existing treaties, which it does not replace. The institutions of the Community (the European Commission, the Council of Ministers, the Court of Justice, and the European Parliament) are "borrowed" to perform functions in the two areas of intergovernmental cooperation based on the Treaty on European Union. The so-called European Council (the meeting of the heads of state or government of the 12 members and the President of the European Commission) is to give political impetus to the process and has been given some decision-making powers. The central position and political importance of the European Economic Community were underscored by the change of its name to the EC (hence, no longer only economic in character). The other two Communities (the ECSC and Euratom) are still alive but are certainly less active than the EC.

European Economic Area

The European Union got off to a slow start on November 1, 1993. Two months later, another ambitious project finally became operative: the so-called European Economic Area.[6] It links the states of the

European Free Trade Association (EFTA)—a free trade zone, established in 1961 as an alternative to the European Economic Community, whose dwindling membership included only the Scandinavian and Alpine countries, owing to defections to the EC—with the common market. Legislation on the single market became effective in Austria, Sweden, Norway, Finland, and Iceland, and it will also apply in Liechtenstein as soon as this state has severed its economic union with Switzerland (the only EFTA member that chose not to join the European Economic Area).

Through the Agreement on the European Economic Area, the economic integration of the continent was brought one step forward: non-EC members have effectively joined the internal market without taking part in the other fields of EC activity or participating fully in the decision-making process in Brussels and Strasbourg.

Second Banking Directive's Place in European Integration

The Second Banking Directive is the cornerstone of the internal banking market.[7] It sets the tone for similar directives in the area of insurance and securities trading. The Second Banking Directive applies, by virtue of the Agreement on the European Economic Area, in 19 states, which are each required to adapt their own legislation to the directive's contents. That is the nature of a directive; it is a binding decision that imposes upon member states the obligation to comply with its terms within a predetermined period left for national implementation.

Because it helps to realize an integrated banking market, the Second Banking Directive can be said to contribute to laying the groundwork for the single monetary policy that will be conducted with the establishment of EMU.[8] This chapter shows that, although there is still some room to improve the Second Banking Directive to bring about a fully integrated banking market and a currency union, the groundwork has been laid.

Structure of the Second Banking Directive

First and Second Banking Directives

The Second Banking Directive is not the only piece of EC legislation on banking supervision. It builds upon, amends, and expands the First Banking Directive of 1977, which was a modest first step toward harmonizing supervisory rules in the common market.[9] This chapter addresses the body of law consisting of the First and Second Banking Directives taken together.

Three Directives on Banking Supervision

The Second Banking Directive was adopted in 1989; it had to be implemented by the member states by December 31, 1992 at the latest.[10] Two accompanying directives were also adopted in 1989; the three together were intended to harmonize banking regulation in such a way that the banking supervisory authorities of the member states could from January 1, 1993 onward rely on each other's supervision.[11] The internal market is based on this system of home state control and on the mutual recognition by the member states of the regulatory framework and its application to the banking system.

It was considered necessary and sufficient that the authorization requirements for banks were harmonized, as well as the main rules to which banks are subject once licensed to operate. These rules are contained in the Second Banking Directive itself, and in the Solvency Ratio and Own Funds Directives.[12] The latter directives lay down the regime of solvency testing for credit risk. They implement in the EC the Group of Ten's agreement on capital adequacy (the so-called Basle Capital Accord).[13] It is interesting to note that a nonbinding understanding as to the capital ratios for internationally operating banks was thus given legal effect in the EC for all credit institutions authorized to operate in the internal market, whether locally or throughout the Community.

Home State Supervision: The Rule and Exceptions to the Rule

Regarding the solvency tests, there is a division of responsibilities in the context of the Second Banking Directive. It was agreed that the state licensing a bank (the home state) is responsible for supervising the bank's compliance with all supervisory rules, especially the solvency ratio, while the state or states where the bank operates have only residual powers.

With respect to these residual powers, the lack of monetary integration in the EC (as yet) made it necessary to stipulate that the host states are responsible for monetary (as opposed to prudential) supervision and for overseeing a branch's liquidity (which, after all, has to do with its funding capabilities in the local currency market). Finally, competences with respect to host state rules, which are indispensable and have not been the subject of harmonization, remain with the host state authorities. In this context, this "general good" exception to the main division of tasks among the supervisors derives from the European Court's case law on the powers of host states to regulate business conducted on their territories by producers or providers of services from elsewhere in the internal market.[14]

Contents of the Second Banking Directive

The Second Banking Directive consists of a long preamble containing no fewer than 23 considerations and 25 articles, divided into six titles. After the first title, which provides the definition and scope of the directive, the conditions for harmonizing authorization requirements are given in the next title.[15] Relations with third countries form the subject matter of the third—and, internationally, the most widely discussed—title, which is placed between the licensing criteria and the rules applying to a bank once admitted to the market.[16] A separate title consists of specific provisions giving procedures for putting into effect the freedom of establishment and freedom to provide services in another member state given by the Treaty on European Union.[17] Matters such as technical amendments and entry into force conclude the text of the Second Banking Directive,[18] to which a list of banking activities subject to mutual recognition is annexed.[19]

Concept of a Credit Institution

The EC has taken an institutional approach to the supervision of banks: all companies and firms that conform to the definition of a credit institution are to apply for licenses before starting business. The definition from the First Banking Directive has been maintained, namely, that a "credit institution" is "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account."[20] There are several striking features of this definition.

- Only a firm that is in the *business* of banking is considered a credit institution. Occasional banking-like activities do not bring a firm within the purview of the EC directives.

- Decisive for qualifying as a "bank" (shorthand for "credit institution") is the solicitation of *repayable funds*. Approaching the public for investments makes a firm an investment company, subject to the securities directives.

- A firm that limits its banking activities to nonpublic activities is not a credit institution. In the Netherlands, banking activities for institutional investors only are considered not for *the public*. Of course, the interpretation of the elements of the definition is ultimately up to the European Court.

- A credit institution is in the business of accepting funds to grant *credit for its own account*. A firm that acts only as an intermediary, bringing depositor and debtor together without committing its own name, will not count as a credit institution.

When these elements are combined, a credit institution is said to exist. EC law requires credit institutions to be authorized and supervised. It follows from the nature of EC legislation that member states may encompass more entities under their banking laws, including companies engaged in other activities under their own definition of a bank. These definitions must, as a minimum, have the scope of the EC's definition. Any discrepancies remaining among state banking laws are lessened by the common list of activities in which a bank may engage once authorized in a single state (provided that its home state license does not restrict its scope of business). This list, which is annexed to the Second Banking Directive, will lead to harmonization in practice as the interpenetration of banks on each others' territories will bring about market forces conducive to an alignment of regimes: out-of-state competitors that are allowed to engage in more activities than local banks are a powerful inducement to adapt banking regulations.[21]

Harmonized Conditions for Obtaining (and Keeping) a Banking Authorization

Reading the First and Second Banking Directives together makes it clear that six authorization requirements apply. First, a credit institution must have own funds.[22] This condition obliges bankers to incorporate. It seeks to ensure that the funds of the banker are legally separate from those of the depositors.

Second, a credit institution must have initial capital of at least ECU 5 million.[23] Sufficient own funds are required to start a banking business, in order to restrict entry to the banking market to serious applicants who can muster a minimum amount of own funds. Of course, the actual business that banks undertake may lead to higher capital requirements under the Solvency Ratio and Own Funds Directives. The solvency requirement is separate from the initial capital requirement. The minimum is to be maintained throughout the life span of the banking business.

The level of ECU 5 million was arrived at through a compromise. The amount is "peanuts" for an internationally operating bank, but it also applies to local credit unions, which are allowed to do business throughout the internal market (through a procedure to be discussed below). A lower threshold of ECU 1 million may be set by the state authorities for specific classes of banks; such a move is subject to European Commission scrutiny.[24]

Third, a credit institution should be managed by at least two persons.[25] The requirement that a minimum of two persons "effectively direct the business of the credit institution" means that its day-to-day management

must be subject to the "four-eyes principle." Effective checks and balances must be present, with a view to "avoiding risky solo operations."[26]

Fourth, the managers of a credit institution are to be experienced and of good repute.[27] Sufficient banking experience will shield a credit institution from incompetence. It should always be borne in mind that a bank solicits funds from the public and is expected to administer and invest them better than the individual depositor would or could. The requirement as to the good repute of bank managers means that only trustworthy people may be at the helm of an institution that is in the fiduciary business.

The high standards to be applied in connection with this fourth requirement have not been specified further in Community legislation, or in that of several member states, where it is considered a matter for the discretion of the central bank or other supervisory authority granting the banking license. Elsewhere, a list of previous acts considered incompatible with the office of bank manager has been drawn up: bankruptcy, conviction for fraud, and similar events are considered to make one unsuitable for running a credit institution.[28] Any decisions on the acceptability of bankers are subject to judicial review. The principle of court review of supervisory decisions underlies Article 13 of the First Banking Directive and also follows from Article 6 of the European Convention on Human Rights (which covers each of the member states and is also applied by the European Court to Community decisions).[29]

Fifth, a credit institution must have suitable shareholders.[30] In addition to the requirement of experienced and suitable management, the suitability of members or shareholders of a bank must also be tested in advance.[31] Once a license has been granted, the continued suitability of shareholders is to be screened by the supervisory authorities under Article 11 of the Second Banking Directive.[32] The sound and prudent management of the bank is the criterion by which to judge the shareholders, and to detect and counter any influence to the detriment of the depositors.[33] Article 11 provides for a continuous notification of changes in membership to the authorities, who must try to neutralize any detrimental shareholders' influence.[34] In some states, this is done by requiring that any exercise of voting rights in a banking corporation that has not been authorized in the most recent scrutiny is null and void or can be declared so on supervisory application by the courts. Thus, harmful influences can be effectively thwarted.

Finally, a credit institution should submit to the supervisory authorities a program of operations.[35] A business plan makes it easier for the authorities to evaluate the request for a banking license. This condition makes it possible to look into the plans of the prospective entrant to the bank-

ing market and test the organization against prudential standards, such as the establishment of sound administrative and accounting procedures, and to see whether adequate internal control mechanisms will be put in place.[36] This condition also makes it possible to evaluate the probability that the bank will conform with solvency requirements and report thereon to the supervisors.[37]

"Reciprocity" or Relations with Third Countries

The issue of reciprocity stirred up much debate during the preparations of the Second Banking Directive. The relevant provisions of the directive set out what the Community can do if it considers that the creation of its single banking market is being used by banks from third countries without EC banks being able to operate just as freely in those countries.[38]

Authorization to Operate Across the Common Market (European Passport)

The six conditions for an authorization to set up a bank just addressed apply to any new applicant from the Community, the other European Economic Area states, or third countries. Member states are free to impose other licensing conditions, provided that they are compatible with the directives. After all, the Second Banking Directive and its companion directives complete the minimum harmonization necessary and sufficient for mutual recognition by EC states of each other's prudential systems. These directives do not purport to regulate banking supervision exhaustively.

Those who wish to establish a bank must go through this licensing process. However, contrary to the pre-1993 regime, setting up a branch or starting cross-border activities in another state is no longer subject to separate licensing by the host state: a credit institution authorized in one member state is granted a "European passport" and may operate throughout the internal market (subject to qualifications to be addressed later). Any legal entity lawfully established in the common market and authorized as a bank can avail itself of the single market procedures for Community-wide banking, irrespective of the nationality of its parent. Under Article 58 of the EC Treaty, any corporation of a profit-making nature established in one member state, whatever its parents, is considered a European legal entity and can avail itself of the freedom of establishment and the freedom to provide services.[39]

Market Access and National Treatment for EC Banks Elsewhere

In the case of applications for a banking license from outside the EC and from the other participants in the European Economic Area, an additional test may be applied. This test concerns the openness of the banking markets in the home country of the applicant.[40] Establishing this condition was meant not as an entry restriction, but as a last resort to ensure that the liberalization of the EC banking market would serve as an example and lead to the tearing down of walls around other lucrative markets. Also, it proved necessary to replace any state reciprocity rules by a Community-wide provision, as otherwise a member state that made entry into its market contingent upon free access to a third market for its own banks would decide the issue for other states as well. Once inside the market, a bank will profit from its European passport and thus circumvent any reciprocity policy applied by another member state. The U.K. reciprocity policy was the most important in this respect, as the London market is the main prize for many outside banks.

Notification of Authorized Entry from Third Countries

Article 8 of the Second Banking Directive requires the supervisory authorities to notify the European Commission of banking licenses granted to third-country banks and of declarations that the supervisory authorities do not oppose a third-country shareholder in an EC bank for prudential reasons (the "suitability" test referred to previously). This reporting requirement gives the EC executive an insight into outside penetration of the single market.

Suspension of Applications from Third Countries

If banks encounter difficulties in establishing branches elsewhere, the European Commission may act. If it finds that "effective market access comparable to that granted by the Community to credit institutions" from third countries is absent, it may propose to the Council of Ministers that negotiations be opened with the country concerned.[41] Should national treatment also be lacking, the European Commission may act on its own and temporarily limit or suspend the handling of applications from the third country concerned.[42] Then, for a three-month period, banks from this country may not start operations in the EC or become shareholders in EC banks.[43] These situations are regulated in Article 9 of the Second Banking Directive.

This power is, however, heavily circumscribed. Apart from the limited period in which it may be applied, the Commission is further subject to

scrutiny by the member states in a "comitology procedure." This strange "Eurospeak" stands for a committee of member state officials that must give its opinion on a proposed act of the European Commission.[44] The executive may act only if this opinion is favorable or the member states do not react to its proposal.

Respecting International Obligations

Thus far, the European Commission has not yet had occasion to submit proposals for specific agreements or to order the suspension of the handling of applications from outside the EC, partly because the treatment of financial services providers was the subject of negotiations in the framework of the Uruguay Round of the General Agreement on Tariffs and Trade. Under the General Agreement on Trade in Services (GATS),[45] an Annex on Financial Services was adopted, which would make it difficult, if not impossible, for the Community to apply its reciprocity regime (which was copied from the banking sector in the insurance and securities fields).[46] It would appear that the agreed GATS texts, although almost inscrutable to an outsider, will, once ratified, end the reciprocity debate.

Meanwhile, the Community is bound to apply its provisions on entry from third countries while respecting its international obligations. This obligation follows from Community law principles and is confirmed *expressis verbis* in Article 9(6) of the Second Banking Directive. This clause was inserted, inter alia, to put to rest the concerns of the Organization for Economic Cooperation and Development (OECD), as national treatment requirements under the OECD codes on liberalizing capital movements and current invisible transactions would make it difficult to apply Articles 8 and 9 of the Second Banking Directive in respect of the non-EC countries among the 25 OECD members.[47]

Unilateral Liberalization of Capital Movements with Third Countries

Since the adoption of the reciprocity clauses, the Community has taken another big step toward liberalizing international financial trade: it included an *erga omnes* obligation to free current and capital transfers in the Maastricht Treaty on European Union.[48] The newly inserted Article 73b of the EC Treaty, which took effect with the start of the second stage of EMU on January 1, 1994, requires complete freedom of financial transactions between the member states *inter se* and between the Community and third countries.[49] Article 73c specifies some exceptions, inter alia, for the reciprocity provisions in directives adopted prior to

1994.[50] Any variations on the current regime may be decided on by a so-called qualified majority in the Council, but any retrograde step on the road to liberalizing capital transactions with the outside world can only be agreed unanimously. Thus, the thrust of the new law is clear: Europe is the only jurisdiction to liberalize financial transfers unilaterally in a constitutional text.

The inclusion of reciprocity provisions in the Second Banking Directive has served a dual purpose: first, it has helped put financial services liberalization firmly on the agenda of international trade politics; and second, it may help the Community gain access to markets elsewhere on a level similar to what it offers to non-European banks and financial institutions through the creation of the internal market.

Harmonized Supervisory Rules

The Second Banking Directive not only regulates entry into the banking market but also lays down rules for the conduct of banking business. Again, other directives play a role here. The Solvency Ratio and Own Funds Directives are particularly important.[51] Directives on the consolidated supervision of banks and banking groups, the annual accounts of banks, their large exposures, and the capital adequacy rules in respect of market risk are directly relevant from a prudential point of view.[52]

The Second Banking Directive itself establishes the following banking rules:

- continued observance of the initial capital requirement;[53]
- screening of shareholders' influence to ensure sound and prudent management of the bank concerned;[54]
- limits on the qualified holdings of credit institutions in other (non-financial) companies;[55] and
- establishment of sound administrative and accounting procedures and adequate internal control mechanisms.[56]

A brief word on each of these prudential rules is called for.

Minimum Capital of ECU 5 Million

The capital requirement was explained previously in the section on authorization conditions. It should not be confused with the solvency requirement for credit risk resulting from the combining of the require-

ments for market risk under the so-called Capital Adequacy Directive with the requirements of the Solvency Ratio Directive.[57]

Suitable Shareholders

The screening of shareholders is an initial requirement that must also be continually applied. It represents a major innovation in EC banking law. Previously, certain member states attached great importance to the vetting of bank owners and used various techniques to do so, ranging from the reaching of an understanding between majority owners and supervisors in Belgium to the placing of legal constraints on the exercise of voting rights in credit institutions in the United Kingdom and the Netherlands.[58] The new rules leave room for national discretion in applying sanctions, but they ensure that a uniform minimum regime will test shareholders' suitability in the internal market. Any shareholder wishing to have a 10 percent participation in a credit institution must have been found suitable.[59]

Limiting Banks' Involvement in Commercial Companies

Also new for some states are the limits placed on a bank's participations in nonfinancial companies. The Second Banking Directive is only concerned with participations of a certain size (so-called qualifying holdings, defined as a 10 percent interest in another company's capital or similar voting rights).[60] It prescribes that such participation should remain below 15 percent of a bank's own funds.[61] Thus, a double computation is required for applying this norm: if the amount of shares or voting rights that the bank holds in a company exceeds the threshold of 10 percent, its stake is limited to 15 percent of the bank's capital. The sum total of these participations may not exceed 60 percent of the bank's own funds.[62] There are qualifications to allow for participations in other credit or financial institutions and (at the option of the member states) insurance companies, as well as for temporary holdings for underwriting purposes or in the context of a financial rescue operation.[63] Because in some banking markets large interests in commercial companies were the rule rather than the exception (Germany and France are cases in point), a ten-year transition period has been established, after which the rules will apply with full rigor.[64]

Adequate Administration and Internal Control

A company receiving money from the public should, as a matter of course, follow adequate administrative procedures. Article 13(2) of the Second Banking Directive does not add much, materially speaking, to

what supervisors (in their oversight of banks) and auditors (in preparing their reports on annual accounts) would require. Including such obvious precepts in supervisory regulation gives the regulators the power to prescribe specifics and test compliance—and, if necessary, act upon noncompliance. Article 13(2) is wide enough in its wording to encompass rules on separating securities and credit departments ("Chinese walls") and on restraining insider trading. A separate directive[65] deals with this matter, but it concerns only stock exchange trading, and prudence and self-restraint are called for in any transaction involving a bank in a dual position, whether in managing its own and its clients' accounts at the same time or in acting as both lender to, and owner of, a company.[66] This provision of the Second Banking Directive creates supervisory competences where they may have been lacking and also makes possible interstate cooperation in enforcing such rules in respect of credit institutions.[67]

Establishment of Branches and Provision of Services

The purpose of harmonizing regulatory and supervisory practices was to create an integrated banking market. As already noted, banks are licensed by the state of their incorporation when they meet certain conditions. They then receive European passports, which authorize, in principle, their operations throughout the Community. It is this qualification—"in principle"—that is to be examined in order to see how the system of mutual recognition functions.

Treaty Rules on Establishment and Services

First, it should be recalled that, under the provisions of the EC Treaty, European legal entities have the right to establish themselves in other member states under the conditions applying locally.[68] Furthermore, they are free to provide services in other member states without operating permanent establishments there.[69]

The European Court has developed case law on the abolition of restrictions on inward provision of services.[70] According to the Court, host states cannot apply their own licensing rules to out-of-state providers of services unless four cumulative conditions are met.[71] The host state rules should be

- justified by the general good (that is, only standards for which a clear public interest can be demonstrated are acceptable);
- nondiscriminatory in character (that is, they should also be applied without distinction to local operators);

- nonduplicative (that is, a mere duplication of professional standards that already apply in the home state is unacceptable); and
- necessary because a less restrictive method of meeting professional standards does not exist (that is, the application of host state rules is subject to a proportionality test in respect of the purposes that they seek to serve).

The application of a state rule on professional standards to an outside provider of services that fails these tests will amount to a prohibited restriction. This case law is in line with jurisprudence on the free movement of goods, known as the Cassis de Dijon precedent.[72] The European Court's decisions have paved the way for implementation of the system of mutual recognition in all areas of economic activity in the common market.[73]

Bank Operations in the Internal Market

Three different situations should be distinguished in the operation of a bank in the internal market. A bank may set up a subsidiary, open a branch, or begin to provide cross-border services.

Establishing a Subsidiary

A subsidiary, that is, a separate legal entity governed by the laws of the host state, still has to apply for a license in its state of incorporation. It is considered a creature of the law of the host state and may avail itself of the facilities of the Second Banking Directive for opening branches and providing cross-border services. A parent in state A may establish a subsidiary in state B and from the latter state may start operating throughout the Community. State B is then the home state for this bank's branch network in the single market. Hence, in the case of subsidiaries, the EC Treaty system for establishment, which requires compliance with host state rules, remains fully in place.

Establishing a Branch

For a permanent establishment in another state without separate incorporation, the Second Banking Directive abolishes the rule of host state authorization.[74] The First Banking Directive allowed branches to be licensed by the host state.[75] The Second Banking Directive goes a major step further and makes the opening of a branch subject to a procedure in which only the home state authorities are competent to take any decision.[76] A bank wishing to "branch out" is to notify its own authorities of its intention to do so. The home state supervisor then checks whether the

bank's administrative structure or financial situation give reason for doubt. If not, the home state supervisor passes the bank's notification on to the relevant host state authorities. The host state supervisor is allotted two months to prepare for the supervision of the branch. The host state supervisor must indicate to the branch which host state rules the branch is bound to comply with in the interest of the general good.

The separate authorization of a branch, extra "branch capital," and the screening of managers by the local regulator have all been abolished. Should the home state supervisor conclude that a bank is not sound enough or lacks the necessary administrative infrastructure to set up a branch in another state, it can refuse to send the bank's notification on to the host state authorities, thus bringing the branch establishment procedure to a halt. Naturally, the bank concerned may apply to the courts for a revision of the supervisory judgment.[77]

Beginning the Provision of Cross-Border Services

A much simpler notification procedure applies when a bank, licensed in state A, intends to provide services in state B.[78] The bank notifies its intentions only to its own authorities, who send the notification on to the host supervisory agency. The bank can then begin operations from its home base. This notification procedure does not imply that any decision is to be made by the home authorities on the soundness or administration of the bank, and there is no waiting period. Nevertheless, in view of the right created by the EC Treaty of free provision of services, the interposition of the notification would seem to be a step backward instead of forward. Arguably, the directive's rules on the provision of services are incompatible not only with the objective of creating a single passport but also with primary EC law (notably, in the EC Treaty, Article 7a on the creation of the internal market and Article 59 on the freedom to provide services). The EC Treaty being of a higher order, the relevant clause of the Second Banking Directive may one day be declared null by the European Court.

Supervisory Cooperation

Consultation and Coordination

The foregoing has made clear that the creation of the internal market has made the supervision of banks operating throughout Europe a matter of cooperation. Not only are supervisors required to inform each other about the standing of a credit institution intending to establish a

bank in another state, but they are also to consult with each other prior to granting a license to a bank with links to another member state.[79] The obligations of mutual cooperation, which the First Banking Directive already contained, have been expanded: supervisors are to inform each other on the ownership, management, solvency, and liquidity of banks operating in more than one state, as well as on questions of, inter alia, administration and deposit guarantees.[80] Home state authorities may send out inspectors to branches in other states, while a mandate from the home to the host state agency to check data or otherwise carry out inspections is also possible. The division of supervisory responsibilities, heavily tilted to the home state, makes such cooperation necessary.

Exchange of Cross-Border and Cross-Sector Information

As banks become more and more intertwined with other providers of financial services, cooperation with supervisors of insurance companies and investment firms has also become necessary. Thus, the confidentiality restraint that applies to all supervisory information has been lifted for such interagency cooperation.[81] Of course, it has also become possible to exchange information among banking supervisors, especially on a cross-border basis.

Common Regime of Confidentiality

The secrecy regime itself has been further harmonized. The First Banking Directive, as amended by the Second, exhaustively lists the uses to which supervisory data may be put.[82] The confidentiality clause has been copied in the other relevant directives and provides for strict secrecy.[83] This European approach to supervision differs from the more open attitude of U.S. regulators. No publication of inspection reports is contemplated in the EC.

Memoranda of Understanding Between Supervisory Agencies

Confronted with the need to cooperate on a hitherto unknown scale, the supervisory agencies in the EC have concluded between themselves memoranda of understanding that set out the instances of mutual information, consultation, and coordination. To a certain extent, these memoranda are repetitive of the Second Banking Directive's language. They also imply certain policy choices where the directive leaves room for interpretation. Regrettably, the agencies entrusted with banking supervision have concluded bilateral accords instead of one multilateral memorandum, if a detailed agreement was indeed necessary at all. Outsiders (credit institutions wishing to operate across the relevant borders, supervisors

from member states other than the two concerned, and those interested from an academic or political point of view) do not know the contents of the memoranda, which, in the end, number so many that nobody has an overview of their provisions.

Cooperation in the Second and Third Stages of EMU

The conclusion of bilateral supervisory accords amounts to a carving up of the supervisory field, which seems harmful to effective regulation of the single market. It would not be surprising if this state authority reflex were in time superseded by the implementation of a more coordinated approach toward banking supervision. The existing coordination forums may provide opportunities for discussion and sometimes action, but they are framed too much like debating committees to operate effectively, especially in crisis situations. The forums are the Contact Group (of supervisors), the EC Banking Advisory Committee (consisting of regulators, treasury officials, and Commission staff), and the Banking Supervisory Subcommittee, which the European Monetary Institute (EMI) inherited from its predecessor, the European Community Committee of Central Bank Governors.

Although the EMU provisions of the EC Treaty do not designate a single authority for prudential supervision, they do provide for coordination among the national authorities, first through the EMI,[84] and then in the third stage of EMU through the European Central Bank (ECB).[85] This new organ, to be responsible for conducting monetary policy with the overriding objective of maintaining price stability, may further be given specific competences in banking supervision.

Amendments (The "Post-BCCI Directive")

The Second Banking Directive was adopted as the cornerstone of the legislation bringing about a single banking market. With the First Banking Directive and the Solvency Ratio and Own Funds Directives,[86] the EC's legislative program seemed complete.

However, since 1989, the revision of the Consolidated Supervision Directive[87] (the 1983 measure was replaced by a new 1992 text) and the adoption of the Large Exposures Directive[88] and the Deposit Guarantee Directive[89] have added to the EC's banking regulations. The screening of market risk incurred by securities houses and banks alike is the subject of a new Capital Adequacy Directive,[90] to be implemented by July 1, 1995; the national implementing legislation is to be applied as from January 1, 1996. These further pieces of legislation still do not conclude the EC's

activities in banking regulation. After the collapse of the Bank of Credit and Commerce International (BCCI), a tightening of supervisory rules seemed in order. Partly on the recommendations of the British committee[91] set up to inquire into the affair, proposals were tabled to amend the Second Banking Directive, as well as other directives concerned with the supervision of banking, insurance, and securities firms. This "post-BCCI" directive went before the European Parliament for a second reading under newly gained "codecision" competences, in which the Council of Ministers and the European Parliament together adopt legislation.[92]

The directive contains a number of innovations. First, it provides that credit institutions will be subject to a further condition for authorization: transparency of group structure.[93] Any credit institution that is the subsidiary of another undertaking or one in which the undertaking has an interest of 20 percent or more must make public its group structure. If the supervisory authorities are not satisfied that they can effectively supervise the bank, they may refuse the license.[94] Thus, a seventh licensing requirement, in addition to those cited earlier in the chapter, is introduced.

A change in group structure that leads to a lack of transparency may lead to revocation of the authorization. Pursuant to Article 8(1)(c) of the First Banking Directive, a license may be withdrawn if the credit institution no longer fulfills the conditions under which authorization was granted.[95]

It was envisaged that the post-BCCI directive would be applied as of January 1, 1996.[96] At that time, another condition for authorization would also apply: a bank's registered office may not be in a state other than that where its head office is situated.[97] This condition, already to be found in the preamble to the Second Banking Directive,[98] will make it possible to deny authorization if it becomes clear that a bank incorporates in another member state in order to evade the supervision of the state(s) in which its main business is located. The BCCI had its registered office and was licensed in tiny Luxembourg while its activities spanned the common market, focusing on the United Kingdom in particular. The European Court's case law on the freedom to provide services and on capital movements always makes an exception where so-called U-turns are concerned, namely, where a firm is established in another state with the objective of evading the rules adopted for the general good by the state on which the economic activities are "targeted."[99]

The scope for exchanging supervisory information will increase: the post-BCCI directive will provide that liquidators, auditors, and central bank departments responsible for the oversight of payment systems will

be included among the categories of persons and bodies with whom supervisory data can be shared.[100]

Finally, the auditors of a bank will have to report to the supervisors any circumstances that may lead to a qualification or refusal of the certificate of audit or that endanger the existence of the bank or imperil its depositors. The auditors will also have to inform the supervisors when principles of sound management are flouted.[101] This kind of cooperation between supervisors and auditors, who may become aware of malpractice at an early stage and whose alertness may greatly facilitate supervision, is not new to some member states. However, the exhaustiveness of the regulation and the scope of this exception to the rules of confidentiality binding auditors and their banking clients are a novelty.

Conclusion

The Second Banking Directive can be said to be a major piece of banking legislation that will determine the shape of European banking supervision for years to come. In line with the European tradition, it provides for universal banking and makes the beginning of operations in the various states of the single market less cumbersome. The directive lays the responsibility for supervision squarely on state authorities and is therefore far removed from any centralizing tendency in banking supervision. "Common rules and separate enforcement" would be an appropriate qualification of the "1992" EC approach.

Although its adoption and implementation may be heralded as an important step both in the creation of a single market and in banking regulation as such, the Second Banking Directive has its flaws.

First, it does not facilitate the establishment of subsidiaries in other states. This lacuna means that banking groups seeking to do business through subsidiaries still have to deal with authorizations in several jurisdictions and separate capital requirements. The option in the Solvency Ratio Directive to mandate a parent bank's authorities to oversee the solvency of its subsidiary may perhaps set an example to be followed in other areas of supervision as well.[102]

Second, the procedures that the Second Banking Directive prescribes for opening a branch and for starting cross-border services in the internal market would seem to contradict the very idea of a single European passport and of nondiscrimination among the depositors in the single market and may conflict with the relevant EC Treaty provisions. The measures adopted for implementing the Second Banking Directive form a net of diverging rules, in which banks wishing to operate in different states

while engaging in different activities on the list annexed to the Second Banking Directive may easily become entangled. What should have been a facilitating measure may then provide another bureaucratic stumbling block to doing business in the Old World.

Third, the approach of state entities overseeing the operations of banks in an integrated market may in the end prove difficult to maintain if large banks develop with equal footholds in two or more states. This system of attribution of responsibilities is likely to be put to the test in crisis situations, as the BCCI case has shown. It may very well be that a European banking supervisory agency may be necessary. At the very least, a central "focus of authority" on the single banking market may have to emerge. In the absence of any other relevant institution with authority across Europe, it may be that the ECB will have to provide this authority. Despite the meager competences given to it in this sphere, the ECB can be said to have the powers to coordinate banking supervision among the national agencies and to provide lender-of-last-resort facilities, if necessary. In the second stage of EMU, the EMI may have to provide the necessary coordination, as a body with a large membership and an advisory—rather than executive—mandate such as the Banking Advisory Committee is not the best suited to provide authority in banking markets.

Fourth and finally, the First and Second Banking Directives and the other EC measures in the area of prudential supervision will have to keep pace with new market developments. In particular, cooperation with authorities in other fields of activity (insurance and securities) and the authorities that oversee the payments systems will need to be reinforced, now that *Allfinanz* groups are becoming the rule rather than the exception and the systemic risks involved in large-value payments systems are the object of justified scrutiny by central banks.

All this does not detract from the importance of the legal text of the Second Banking Directive. It remains a central and innovative banking law, albeit one that may not last unaltered for very long into the next century. Nevertheless, by then it may have contributed significantly to a reinforcement of supervisory cooperation among authorities who, ten years ago, saw their colleagues only at conferences. The Second Banking Directive may have helped the banking laws of many nations converge, not only in the West, but also in Eastern Europe, the Baltic countries, Russia, and the other countries of the former Soviet Union, and perhaps even in other continents. There is a keen interest in the European banking laws in other countries and in international organizations. Finally, the Second Banking Directive's main contribution may be the realization, however slow and despite unwarranted red tape, of an integrated banking market in Europe.

Chapter 7

Banking Law Developments in the European Union: Deposit Insurance and Money-Laundering Initiatives

PAOLO CLAROTTI

Introduction

The European Community (EC) banking legislation covers all credit institutions that receive deposits and similar repayable funds and that also grant credits, unless there is specific provision for an exemption. This fundamental principle was established in the Council's First Banking Directive of 1977.[1] The trend since that date has been to reduce the number of exempted institutions. The motivation, as put forward in the recitals to the First Banking Directive, was a mixture of prudential and competitive considerations:

> . . . equivalent financial requirements for credit institutions will be necessary to ensure similar safeguards for savers and fair conditions of competition between comparable groups of credit institutions. . . .[2]

All types of credit institutions are, in principle, treated in the same way, and there is thus equality of competitive conditions in relation to prudential rules: the famous "level playing field."

All member states have experienced, to varying degrees, the process of "despecialization," in which some if not all providers of financial services have broadened their scope of activities and have begun to compete in new markets. Traditional areas of specialization and the demarcation of activities between groups of credit institutions have been eroded, largely as the result of market forces. The Second Banking Directive of December 1989[3] reflects this development by incorporating a full range of banking services in the scope of a single banking license. Such a development needs to be underpinned by the enforcement of common prudential standards for all banks. This principle is well demonstrated in the case of the Solvency Ratio Directive, under which the same risk weights and overall capital requirements apply without reference to the composition of business of the credit institution in question.[4] For example, the same capital requirement applies to a mortgage credit extended by a specialized mortgage credit institution as to a mortgage credit granted by a truly universal bank or a bank that typically concentrates on trade finance.

During the course of the discussion leading up to the adoption of the Second Banking Directive, several requests were made for the development of two sets of final prudential standards, with one set applicable to those institutions operating across national boundaries, and another, unharmonized or partially harmonized set applicable to those confining their attention to purely domestic markets. It was decided that to take such a path would have been inconsistent with the basic freedom to supply services conferred by the Treaty of Rome—a freedom that is available to all—and with the aim of achieving equality of competition between institutions.[5] Clearly, those credit institutions operating across the EC compete in the national markets of those engaging only in domestic business.

The EC's banking legislation seeks to protect depositors and to safeguard the integrity of the European system. In other words, it pursues on a Community-wide scale what national supervisory authorities have been undertaking for decades. The Freedom of Capital Movements Directive[6] and the Second Banking Directive are the foundations for the internal market in banking services. The framework laid down in the Second Banking Directive has been an enormous step forward for member states, which have had to change radically the process by which they have traditionally supervised such institutions. Under this framework, supervision of credit institutions has been undertaken since January 1, 1993 by the home member state; also, a bank, once established, can branch freely throughout the Community. Member states have to allow branches of banks registered in the EC to operate on their territories without any prior applications being made. To bring about such a change, it was necessary to ensure that supervisors knew that certain minimum standards were being applied by their fellow supervisors in other member states. Any credit institution established in any member state has therefore to comply with a number of conditions before it can be licensed to operate throughout the EC.

A necessary condition for achieving a single banking market was the elimination of the remaining capital controls in member states by the end of 1992. This necessary step to secure a fully integrated banking market was achieved in most countries by July 1990. However, a few countries were allowed to maintain certain restrictions until 1992, and Greece was allowed to maintain them until June 1994.

The supervisory rules are in the process of being redefined at a time of considerable change in the financial markets. Indeed, these rules are being redefined in order to prepare for major changes in the European market and to enable them to take place. For this reason, it seems especially important to draw up strong prudential guidelines. It would be wise to err on the side of caution rather than to set inadequate standards. The

financial system survived the October 1987 stock market crash, but it would be wrong to be complacent. It seems equally important, at a time when the 15 national markets are about to fuse into one and money and capital markets have an international dimension stretching beyond the European time zone, that European banking legislation should be readily adaptable in the event of further changes in market structure and financial instruments.

The fact that the standards set in the EC legislation are minimum standards helps to make such adaptation easier. Member states are always free to apply tougher standards if they judge it necessary to do so. These minimum standards range from the minimum level of capital required to the fitness and suitability of directors. These standards not only comply with international standards but are also among the highest for credit institutions.

In this framework, cooperation among the respective supervisors becomes paramount. They will have a duty to consult with each other in the supervision of institutions operating across borders. More important, EC legislation has removed all barriers on banking secrecy that might prevent important information from being passed from a supervisor in one member state to a colleague in another.

Equally important, the European Commission has been working to ensure that its liberal trade philosophy, which allows financial services to be provided to the customer in a competitive environment with the greatest possible choice, is extended beyond the frontiers of the member states. This is witnessed, for example, by the Commission's commitment to a strong financial services agreement emanating from the Uruguay Round negotiations in Geneva and by the discussions that it has had with its European Free Trade Association neighbors, which concluded with the signature of the treaty creating, from January 1, 1994, a single European Economic Area.[7]

The EC has succeeded in getting the 15 member states to agree on a system that is opening up markets, some of which had been relatively closed and underdeveloped, while giving adequate protection to the savers, investors, and other users or consumers of financial products. This chapter focuses on the contents of two directives approved according to the above framework: the Deposit-Guarantee Directive;[8] and the Money-Laundering Directive.[9]

EC Directive on Deposit-Guarantee Schemes

Two essential reasons justify the setting up of deposit-guarantee schemes: first, the need to protect the depositors; and second, the need

to ensure the stability of each bank and of the banking system in general. The schemes in question protect all those who are poorly informed about financial problems and, consequently, reduce the systemic risk resulting from depositors' fears of not being able to recover their funds from a bank in crisis. These fears are the cause of runs on banks, which are extremely detrimental for all the banks that experience them. Systemic risk comes into play in this connection because, on the one hand, the interbank connections are today so close that a crisis affecting one bank is likely to involve others and, on the other hand, the well-known phenomenon of imitation can cause depositors with other banks to run to those banks even if they are not in crisis. Therefore, the guarantee schemes protect the banking system from the risk that depositors will withdraw their funds not only from banks in difficulty, but also from relatively healthy banks that could be the victim of unfounded rumors.

One of the fundamental principles involved in setting up a deposit-guarantee scheme is that the costs of such an operation, or the possible distortions caused by the existence of these systems, are more sustainable than the costs that a massive withdrawal of banking deposits would cause for the whole economy.

The 1986 Recommendation

In December 1986, the European Commission published a recommendation, almost ten years after the First Banking Directive, aiming to establish deposit-guarantee schemes. At that time, only six member states (Germany, Belgium, France, the United Kingdom, the Netherlands, and Spain) had one or more deposit-guarantee schemes.[10] The 1986 recommendation invited the six member states that did not have deposit-guarantee schemes to introduce them by January 1, 1990.[11] The six member states where deposit-guarantee schemes already existed were invited to check that such systems

- guaranteed compensation for depositors who did not possess the means of properly assessing the financial policies of the institutions to which they entrusted their deposits;
- covered the depositors of all authorized credit institutions, including the depositors of branches of credit institutions that had their head offices in other member states;
- distinguished sufficiently clearly between intervention prior to winding-up and compensation after winding-up; and
- clearly set out the criteria for compensation and the formalities to be completed in order to receive compensation.[12]

In the preamble to the recommendation, the Commission reminded the member states of the proposal for a directive concerning the coordination of the provisions on reorganizing and liquidating of credit institutions that it had forwarded to the Council earlier in 1986.[13] This proposal contained "a transitional provision stipulating that, pending the entry into force [of the above recommendation] in each member state, the guarantee schemes in which credit institutions take part [have to] extend cover to deposits received by branches set up in host countries which have no guarantee scheme."[14] It was a sign of the type of solution that would later be generally applied.

However, an amendment to the proposed directive stipulated that, as soon as that recommendation had been applied in all the countries, a branch of a bank with its head office in another member state should join one of the systems existing in the host country.[15] This proposal for a directive expressed the approach favored at that time, whereby each bank had to form part of the deposit-guarantee scheme of the host country. This approach was, moreover, already in force in the six countries that by 1986 had adopted deposit-guarantee schemes. Germany, however, was an important exception because the guarantee scheme set up by its commercial banks' association covered branches situated abroad.

What was the member states' reaction to the recommendation? For the six member states that already had deposit-guarantee schemes, their only "obligation" (legally, it was not one) was to conform to the four criteria mentioned above. In practice, all the countries did so; however, there were some difficulties. In Belgium, foreign banks' branches were not covered automatically by the local guarantee scheme; it was considered that the guarantee scheme (if there were one) of the country where the bank had its head office had to cover that branch. However, the entity managing the guarantee fund had the option to stipulate agreements with the corresponding bodies of foreign countries, in order to organize with their cooperation possible mutual assistance in the event that a crisis befell that branch. In addition, the public banks were not covered by the guarantee fund because they enjoyed a state-provided guarantee. In Spain, too, the public banks were not covered. Neither were establishments specializing in mortgage or consumer credit.

With regard to the six countries without deposit-guarantee schemes, the situation developed as follows. While Italy and Ireland had already studied the possible implementation of deposit-guarantee schemes, it was Denmark that introduced the first scheme with the passage of a law on October 28, 1987.[16] Italy followed immediately with the approval on November 4, 1987 of the Articles of Association of the Interbank Guarantee Fund (a private fund).[17] In Ireland, a law on the deposit guar-

antee was adopted on July 12, 1989,[18] and, in Luxembourg, a private interbank fund was set up on October 2, 1989.[19] Greece also has a deposit-guarantee law, [20] as does Portugal.[21] Given that the majority of the banking system is not in the hands of the state in either Greece or Portugal, it is more convenient and practical to set up deposit-guarantee schemes by legislation, rather than through interbank agreements, as these agreements are difficult to achieve between public and private banks. (As exceptions to this general rule, interbank agreements were in fact carried out in Italy and France; in the latter country, agreement was reached before the nationalization of the core of the banking system). In Italy, while foreign bank branches can join the Interbank Guarantee Fund, none have joined as yet; there is therefore an important gap in the coverage of deposits.

The 1992 Proposed Directive

Thus, despite the 1986 recommendation, two member states had by 1992 not yet established deposit-guarantee schemes, and others had applied them only partially. Moreover, only limited progress had been achieved in the harmonization of the prudential rules. As a result, the European Commission forwarded on June 4, 1992 to the Council of Ministers a proposal for a directive to give a binding framework to deposit guarantees in the member states.[22] The provisions of this proposal for a directive responded therefore to a need and took account of the experience gained in implementing the 1986 recommendation, as well as of the crises befalling some institutions with branches in several member states. In the proposal, depositors' protection was based on the principle that deposits had to be guaranteed by the scheme in force in the member state where the bank had its registered office (home member state), even if the deposits had been made with branches in another member state.

With the completion of the internal market, all the activities that a credit institution carries out in its branches throughout the EC will be subject to the same accounting and evaluation rules, the same layout of profit and loss accounts, and the same solvency rules. According to the opinion of the Banking Advisory Committee, ignoring the "country of origin" principle in a field as closely connected with banking supervision as that of deposit-guarantee schemes would have set "a dangerous precedent for the completion of the internal market of banking services."[23] The completion of this market will therefore involve the coexistence in the same territory of several deposit-guarantee schemes. However, the experience of the member states—in which, for a number of years, different categories of credit institutions have been carrying out their activities while being covered by different guarantee schemes—proves that

such a solution can work well, especially if the minimum cover fixed by the directive ensures that depositors with small savings will be equally compensated in all the member states.

The 1986 recommendation did not fix a harmonized minimum cover. In 1992, however, it appeared essential from the point of view of completing the single market that depositors should benefit from basic protection, whether they had deposited their money with a credit institution having its head office in the member state where they resided or in a branch of a credit institution established in another member state. The European Commission considered that the minimum cover fixed for the EC should not be too high, in order to avoid what had occurred in the United States, where the risks incurred by the individual depositors had been reduced so much because of the high covers that the depositors had been completely indifferent to concerns about the soundness of their banks. Moreover, in that situation, the managers of the banks had been prompted to assemble high-risk portfolios without facing the discipline of the market (that is, without having to pay high premiums with their guarantee schemes), with the result that the risk of insolvency had increased. Thus, the profits had benefited the banks, while the losses had been charged to the guarantee schemes. Conversely, the minimum cover must not be too low or exclude too large a number of deposits from the minimum protection threshold.

Because direct statistics on the size and distribution of the deposit accounts in Europe were not available, it appeared reasonable to try to fix a minimum cover based on the current levels of the guarantee schemes in the member states (see Table 1). If one excludes the two member states (Germany and Italy) in which the protection level is extremely high and those members where there has been no protection (Greece and Portugal), the median level is approximately ECU 15,000—the figure that was used in the Commission proposal of 1992.[24]

At the time of the elaboration of the proposed directive, the question arose as to whether it would not be preferable to fix a refunding limit in percentage terms, which would have more of a leveling effect but be less protective of the small depositors. This solution was not adopted because it would have involved important modifications of certain solidarity systems aimed at rescuing failing establishments and, therefore, would have called into question the concept of integral compensation for its depositors. The compromise solution finally adopted makes it possible to limit the guarantee to a percentage of the deposit by requiring that at least 90 percent of the deposits be covered up to the limit of ECU 15,000.[25] Beyond this limit, member states or the schemes are free to refund at lower percentages or even to refuse to make guarantees.

Table 1. Levels of Depositor Protection in Member States Having Deposit-Guarantee Schemes[1]

Country	Amount in ECU	Amount in National Currency
Spain	10,000	Ptas 1.5 billion
Belgium	12,500	BF 500,000
Luxembourg	12,500	Lux F 500,000
Ireland	18,000	IR£ 15,000
Netherlands	15,500	f. 40,000
United Kingdom	25,000	£ 20,000
Denmark	33,000	DKr 250,000
France	60,000	F 400,000
Italy	525,000	Lit 1 billion
Germany	In practice, unlimited[2]	

[1] Based on the most recent available data, these figures give only a summary indication of the existing protection levels because the characteristics of the various systems in the member states are not comparable. In some cases, the figures given in the table represent the actually refunded maximum amounts; in others cases (Ireland, the United Kingdom, and Italy), although the figures represent the maximum amount taken into consideration in the intervention of the guarantee fund, the actually refunded amount is only a percentage of that total.

[2] In theory, there is a limit: 30 percent of the own funds of the bank in crisis by depositor. However, if the crisis involves a large bank, the cover is practically unlimited. In the case of banks of smaller size, the limit is purely theoretical, for no saver deposits substantial amounts in these banks.

Most of the existing guarantee schemes envisage that depositors will be refunded relatively rapidly, but, until now, this refunding has often depended on the progress made in the liquidation procedures and the diligence of the liquidators named by the courts. This process, which involves deadlines, has caused understandable disarray among depositors. It also is a source of numerous disputes, which can slow down the refunding. The proposed directive envisaged a starting point for refunding that was unconnected with the insolvency procedures.[26] It was considered that, if the deposit were unavailable for more than ten consecutive days, it should be possible to begin payment of the guarantee, which should be completed within three months, except in certain circumstances.[27] The decision to set the deadline at three months resulted from the practical experience of the guarantee scheme managers. It was further envisaged that, if this three-month period could not be respected, the evaluation of the deposits under the guarantee scheme could follow the same legal procedure used for liquidations, which covered inheritance problems and necessarily took more time.

In this connection, as touched on previously in the chapter, it should be emphasized that depositors must be informed of the extent of the protection of their deposits. Complete information is also important to reduce the systemic risk; indeed, the more depositors are aware of a risk, the more attentively they will make inquiries about the sound management of the institutions to which they entrust their deposits and the less sensitive they will be to unjustified rumors.

Several points were not included in the proposed provisions. First, regarding the legal status of the guarantee schemes, in the EC, and even within the member states, private deposit protection systems coexist with systems regulated on a legislative basis. Most private systems fall under the responsibility of professional entities, and they are just as sound as the schemes managed by, or with the assistance of, the public authorities. Therefore, it was considered convenient not to modify this state of affairs by compelling the member states and the credit institutions to be subject to a guarantee scheme based on a harmonized statute. Second, there are also major differences with respect to the financing mechanism. If a guarantee fund exists, the credit institutions periodically pay contributions to the fund according to the value of their deposits or some other yardstick; these funds are managed by the guarantee schemes themselves. If no fund exists, the financing of the guarantee scheme is ensured by commitments to pay on the part of the member credit institutions, which are then paid to the scheme only if a bank defaults. Finally, some financing systems are mixed, that is, there are permanent funds to which may be added exceptional contributions in the event of a bank crisis. The Commission, having been convinced that the various financing mechanisms were sufficiently sound to compensate all the depositors covered, including those with branches located in other member states, considered that it was not useful to harmonize rules that were closely connected with the management of the schemes in question.

The European Commission, however, considered it advisable to harmonize at least partially the scope of the directive with regard to the deposits benefiting from the guarantee and the credit institutions covered by it. In the first area, some deposits were excluded from the guarantee—interbank deposits, for instance. This exclusion is justified by the assumption that banks are supposed to recognize better than other entities the symptoms of a troubled bank. Subordinated debts were also excluded by contract from the guarantee so as not to have priority over any other creditor of an ailing institution. Moreover, member states can permit certain depositors or certain categories of deposits mentioned in an annex to the directive to be excluded from the guarantee.[28] These exclusions concern mainly the deposits of other financial institutions, insurance companies, the government, and the local authorities. However, the number of

institutions and persons involved is large, and the assessment of the necessity of their exclusion can vary from one member state to another, making it impossible to achieve a more complete harmonization in this area. The situation of these institutions and depositors largely depends on the amount of the guarantee granted by the system and on national traditions. Thus, several systems cover bearer deposits under certain conditions because most of the smaller savers have recourse to them, whereas some other countries prefer to exclude them. The list appearing in the annex to the directive is restrictive, and the member states will not be able to exclude from the guarantee institutions and persons not mentioned there, as any further exclusion would be against the directive.

Concerning the credit institutions covered, two fundamental principles were expressed in the proposed directive. The first principle is that membership of all the authorized credit institutions in a deposit-guarantee scheme should be mandatory.[29] The introduction of at least one deposit-guarantee scheme in each European member state had already been recommended by the European Commission in 1986. The 1992 directive not only renewed this requirement (which had not been satisfied in two member states) but made compulsory the membership of any authorized bank. The second principle is that the home country of an institution is responsible for the guarantee scheme for branches established in other countries.[30] This principle was supplemented by a provision intended to allow the depositors of branches located in other countries to benefit from the advantages of the host country's guarantee scheme by giving them the option of joining that scheme.[31] This is not, strictly speaking, an exemption from the principle of the responsibility of the home country system, which must guarantee the depositors of the branches up to the amount offered to the depositors of the institution's head office, but it is to some extent a complementary guarantee, which can be obtained whenever the managers of the branches deem it useful—from a competitiveness viewpoint—to make their customers beneficiaries of the host country scheme.

In conclusion, the directive was intended to ensure a minimum protection of depositors, based on the principle of "home country control." However, it did not forbid member states from envisaging a broader coverage than the minimum provided. Moreover, the proposed directive allowed branches abroad to join the deposit-guarantee scheme of the host country if it were more favorable to the depositor than the scheme of the home country.

Adoption of the Proposed Directive

The three competent bodies—the Economic and Social Committee, the European Parliament, and the Council of Ministers—examined the

proposed directive on deposit-guarantee schemes. The Economic and Social Committee delivered its opinion on October 22, 1992. The European Parliament delivered its opinion at its session of March 10, 1993. Following these opinions, the European Commission forwarded to the Council of Ministers on June 7, 1993 an amended proposal containing two important modifications of the original proposal. First, it was proposed that the minimum cover level should be raised to ECU 20,000, to take account of the reduction in the value of the ECU following the crisis in the exchange rates of the Community currencies.[32] Second, it was proposed that the solidarity systems existing in certain member states, in particular with regard to the credit cooperatives and the savings banks, should be treated as deposit-guarantee schemes.[33] Therefore, there would no longer be an obligation to create deposit-guarantee schemes for an institution whose depositors were already indirectly protected by solidarity systems.

Following the amended proposal, the discussions within the Council accelerated; on October 25, 1993, agreement on a common position was reached. In this common position, the two modifications mentioned above were adopted. The initial text of the Commission was also amended on other important points. One point relates to the verification of the unavailability of the deposit (the starting date of the compensation procedure) through a court order or an act of the supervisory authority. In addition, the three-month period within which the guarantee has to be paid was modified. Additional such periods could be permitted, as dictated by exceptional circumstances.[34]

The Council of Ministers also introduced, for a transition period through the end of the century, a clause of "nonexport," which suspends the application of the rule whereby the depositors of branches in states other than that of the head office are compensated up to the amount planned for the depositors in the state of the head office when the latter amount is higher than that paid by the guarantee scheme of the host country.[35] During the transition period, the depositor will receive the amount of the guarantee in force in the host country.[36] This provision aims to avoid distortions affecting competition in the host country due to the difference between the two amounts. The decision to set a transition period is intended to allow banks with their head offices in other countries to explain to their customers the reasons for this difference and to reassure them on the probabilities of a bank failure. In the long run, any competitive aspect related to the different amounts of the guarantee granted by the respective systems should be removed; nevertheless, whatever the reasons that led the Council to amend the text proposed by the Commission, it is difficult to conclude other than that the solutions selected worsened the situation of depositors in the short term.

The European Parliament's second reading took place on March 9, 1994. Amendments restoring depositors' rights and certain other criticisms were considered. In view of the entry into force of the codecision procedure provided for in the Treaty on European Union, a conciliation procedure was set in motion.[37] The conciliation committee met on April 12, 1994, and complete agreement was reached between the Parliament and the Council. Among the amendments of the Parliament that the Council accepted were the obligation for the supervisory (or legal) authorities to check the unavailability of the deposits within 21 days, the obligation for the guarantee scheme to compensate depositors at the latest a year after the verification in question, the obligation for the Commission to review the minimum amount of the guarantee every five years, and the addition of a right of recourse to the guarantee scheme for the depositors. The Deposit-Guarantee Directive was adopted on May 30, 1994.[38]

EC Directive on Money Laundering

Background

The process of financial globalization will benefit individuals' undertakings and enhance legitimate business, but it will also open enormous opportunities for criminals to place and move the proceeds of their criminal activities, to disguise the source of the money, and to invest it profitably. This is the phenomenon of "money laundering." The international nature of money laundering can be considered as having three different aspects: first, the proceeds to be laundered mainly come from internationally organized crime, such as drug trafficking; second, the laundering procedure usually involves the transit of money across international borders; and third, the practice is difficult to combat exclusively at the national level.

How was the EC prepared to face this important challenge of money laundering before the first proposal for an EC Directive had been made? In 1990, the laundering of drug money did not constitute a crime in any member state other than the United Kingdom.[39] Only in some cases could the first stage of the laundering process constitute a crime, namely, if the person receiving the proceeds had obtained an advantage from the crime similar to the offense of "handling stolen goods." Money laundering was not even considered as an administrative infraction punishable under banking legislation. With the exception of the United Kingdom, financial institutions in the EC were allowed to close their eyes to money-laundering operations. If the law enforcement authorities required some

information, owing, for instance, to a related investigation, the financial institutions might refuse to cooperate by invoking bank secrecy. These institutions were in no way obliged to report suspicious transactions to the competent authorities. The simple denunciation of a suspected transaction was even prohibited in many EC countries. In brief, the reality of money laundering was practically ignored by nearly all member states' legislation.

In December 1988, two significant steps were taken at the international level to combat money laundering. First, the United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (the Vienna Convention) required the criminalization of money laundering as an essential element in the strategy to fight drug trafficking.[40] Second, the Basle Statement of Principles, which properly underlined how money laundering constitutes a clear violation of good banking practices, drew attention to the need to adopt appropriate measures to prevent the use of the financial system for these purposes.[41]

The European Commission was aware of the danger that money laundering represented to the soundness and stability of the European financial system. It had already started preparatory work by sending a questionnaire to the member states in June 1987. A working party was convened on this subject in October 1988. The Basle Statement of Principles in 1988 and the creation of the Financial Action Task Force (FATF) in the autumn of 1989 gave a decisive thrust to the international movement against money laundering.[42] Following a first draft of measures prepared in October 1989, the European Commission presented to the Council of Ministers a proposal for a directive on money laundering in March 1990, which, after discussion by the European Parliament, was finally adopted in June 1991.[43]

Objectives and Specific Provisions of the Directive

This directive has three main objectives. The first objective is to prevent criminals from taking advantage of the single internal market to carry out laundering operations that could jeopardize the soundness, stability, and integrity of the EC financial system. The second objective is to prevent member states from adopting restrictive measures inconsistent with the single market for the purposes of fighting money laundering. The third objective is to contribute, within the limits of its competence, to opposing organized crime in general and drug trafficking in particular. In this context, the directive on money laundering constitutes a major element of the European plan to combat drugs adopted by the Community and the member states in December 1990.[44]

The directive is not a set of political guidelines but a binding legal instrument that obliges the member states to implement it in their national legislation before a specific deadline (in this case, January 1, 1993).[45] No other international instrument affecting money laundering is immediately binding on the member states. Another important feature of the directive is its universal coverage of the financial system. Banks, saving institutions, building societies, life insurance companies, securities firms, leasing companies, credit card issuers, and money changers, among others, are covered. No financial operator falls outside the scope of the directive.[46] Moreover, a specific provision obliges the directive to be applied to nonfinancial categories of professions and undertakings that could also be used for money laundering.[47] As it was not considered appropriate to make an exhaustive list in the directive of these professions and undertakings, a contact committee was assigned to examine, inter alia, whether a specific category should be included in the scope of the directive when its use for money laundering had been established in one or more of the member states.[48]

In defining money laundering, the directive includes as mandated the laundering of proceeds from drug-related offenses, along the lines of the Vienna Convention of 1988. However, the directive underlines that the phenomenon of money laundering is not confined to the field of drugs, and it provides a legal framework so that member states may extend the scope of the directive to cover other serious crimes.[49] As a matter of fact, most member states are implementing the directive so as to include the laundering not only of drug money but also of proceeds from other serious crimes. Legislation already existing in the United Kingdom, for example, covers drug offenses and terrorism. This line of not limiting money laundering to the field of drugs has also been followed by other international instruments, including the Basle Statement of Principles, the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime (recently ratified by a majority of member states), and the FATF recommendations.[50]

The money launderers' business will become difficult in the Community, as money laundering will be prohibited and duly punished in all the member states. Traces of financial transactions will be preserved. The practice of bank secrecy will be lifted to permit investigations in this field. Active cooperation between financial institutions and law enforcement authorities will be ensured by a system for reporting suspicious transactions.

The rule "know your customer" implies not only that anonymous accounts or passbooks or anonymous safe custody facilities will not be allowed in the EC but also that occasional customers carrying out single transactions amounting to ECU 15,000 or more must be identified.[51]

Identification of beneficial owners will be required whenever customers do not appear to be acting on their own behalf.[52]

The principle of "traces must remain" is also of great importance in facilitating money-laundering investigations. The directive provides that financial institutions must keep a copy or references of the customer's identification document, as well as supporting evidence and records of all transactions.[53] In this way, it will be possible to rebuild the transactions a posteriori and to retrace the path of criminal proceeds.

The principle of "due diligence" means that financial institutions will no longer be allowed to close their eyes when dealing with unusual transactions whose lawful purpose is unclear.[54] As such transactions are likely to be used for money laundering, banks must be diligent and examine them with special attention to fulfill their other obligations under the directive. This provision is linked to the financial institutions' obligation to set up appropriate internal control procedures.[55] Moreover, one of the recitals of the directive recalls the need to apply this principle of due diligence in the particular case of transactions carried out with third countries that do not have equivalent standards in this field.[56]

Preventing the invocation of bank secrecy in money-laundering investigations is another essential rule.[57] It is not that bank secrecy is questioned in itself; clearly, the relationship between banks and their customers is founded on confidence, and an unjustified disclosure of information to third parties constitutes a breach of the banks' contractual obligations. However, when the essential values of the society are in jeopardy, as in cases of criminal law, the general good must prevail, and the veil of bank secrecy must be lifted. This principle is accepted in many countries throughout the world and is also included in the Vienna Convention. The criminalization of money laundering is a precondition for the proper application of this principle.[58]

Lifting the practice of bank secrecy when the penal authorities request information in the context of a legal proceeding—which is not contested in most countries and is usually considered sufficient to combat crime in general—is not enough to combat money laundering. First, judges and policemen are removed from day-to-day financial operations and often lack the necessary expertise. Indeed, if only the information requested by these authorities were supplied, most money-laundering operations would go unpunished. Second, the traditional legal means do not suffice in themselves to win the battle against this new kind of criminality, which is characterized by an extraordinary flood of criminal proceeds (mainly coming from drug trafficking) and the use of sophisticated international financial techniques to disguise the origin of the funds. A specific provision has thus been included in the directive, according to which financial

institutions are obliged to report any suspicious transactions to the law enforcement authorities.[59] As a matter of fact, ensuring the transmission of information to the competent authorities is the most effective way to maintain the integrity of the financial system, as well as to provide these authorities with the necessary material to succeed in the battle against money laundering.

This important bank secrecy provision of the directive has been inspired by British law. In other EC countries, the implementation of this clause requires not only adoption of new legislation but also modification of important traditional legal principles. However, all the member states have agreed that implementing a system of mandatory reporting is more efficient, less expensive, and less cumbersome than adopting the kind of routine reporting system used in certain third countries. Simply giving financial institutions the discretion to report could have been misinterpreted in some member states, in that the option of informing the authorities about a suspected transaction might be a matter of free election without legal sanction.

Nevertheless, cooperation between financial institutions and law enforcement authorities should be carried out without disregarding in any way the essential principles of law that safeguard the rights of customers and financial institutions. These principles have been fully respected in the directive. The general rules in the member states' legislation on presumption of innocence and burden of proof are not affected; financial institutions and their employees are exempted from responsibility of any kind when they report in good faith suspicious transactions to competent authorities; the authorities receiving the information must be the competent authorities for combating money laundering; finally, the information received by the authorities should be used only for money-laundering investigations unless the member states' national legislation provides otherwise.

Why does the directive not provide a definition of "suspicious transactions" in order to facilitate implementation? Any definition or list of suspicious transactions would necessarily be incomplete, as it is not possible to reflect in a directive or in a text of primary legislation the specific criteria covering the numerous modalities of money-laundering transactions that have currently been identified or that could be invented by criminals in the future. Member states shall establish, however, the guidelines needed for identifying patterns of money-laundering transactions in order to help the financial institutions carry out their reporting obligations. This step was taken by the Bank of England some years ago when it published guidance notes for banks and other financial institutions.[60] However, these guidelines, which should be flexible and easily adaptable

to changing reality, should remain confidential and unavailable to the financial institutions' employees not directly responsible for reporting, as well as to customers and other third parties. In preparing these guidelines, the exchange of information on money-laundering methods and transactions patterns carried out in the framework of the FATF will be extremely useful. In the EC, the contact committee created by the directive will also be a helpful forum for coordinating criteria on this matter and other practical problems.[61]

In discussing the directive, two other important provisions are worth mentioning. First, financial institutions must establish adequate internal control procedures to detect and prevent money-laundering operations. Second, these institutions must ensure their relevant employees' participation in special training programs on this matter.[62] The specific way in which such control procedures and training programs should be organized is not detailed in the directive, but it is clear that the member states shall be obliged to take the measures needed to ensure the fulfillment of these obligations by financial institutions.

When duly implemented by the member states, the directive will constitute an effective mechanism to prevent money laundering in the EC financial system. The FATF's core recommendations are contained in it.[63] The directive will not produce integral harmonization of the member states' legislation in this field; however, the purpose of the directive is not to create a uniform mechanism in Europe to prevent money laundering, but to ensure that the national standards in this field are appropriately high and converging at the appropriate rate. For instance, the kind of sanctions to be applied against infringements on the obligations provided for in the directive, as well as the authorities responsible for controlling the implementation of such obligations, will be decided by the member states according to the peculiarities of their legal systems. This diversity, which is inherent in the EC, should not affect the efficiency of the mechanism for preventing money laundering in Europe, provided that the directive is duly implemented in the member states and that the national systems work properly.

Nevertheless, much work needs to be done to ensure proper implementation of the directive. Most member states have already adopted the necessary legislation, and the European Commission must make every effort to confirm that such legislation is consistent with the directive.

The Money-Laundering Directive is based on a financial approach implemented according to the EC competence and does not include all the measures that could be used to combat money laundering. The machinery provided for in the directive fulfills its specific function either by preventing the carrying out of money-laundering operations or by

making available to the competent authorities the information that they need to proceed with their investigations. The machinery needs to be complemented with other measures to ensure that criminal assets will be frozen, seized, and confiscated wherever they are located in the EC; that evidence may be used in the different jurisdictions; and that money launderers are duly punished regardless of where they are discovered. Achieving these goals requires improved systems of police and judicial cooperation, which cannot be accomplished by the directive, owing to its financial approach and the EC competence. For instance, the FATF recommendations on international cooperation, judicial assistance, and the freezing, seizure, and confiscation of criminal proceeds should also be followed by the member states.[64] The ratification and implementation of the Vienna and the Council of Europe Conventions, as provided for in the member states' statement annexed to the directive, are of paramount importance to this end.[65]

An aspect that should contribute to enhancing the effectiveness of the EC mechanism is the application of equivalent money-laundering standards in as many countries as possible in the world and the enhancement of international cooperation in this field. Otherwise, although criminal proceeds would be deflected from the EC in a first stage, they would ultimately enter into its financial system in a second stage, after being "prelaundered" outside.

As previously mentioned, six of the seven European Free Trade Association (EFTA) countries and the EC have signed the Agreement on the European Economic Area.[66] This led to the creation of a "Great Market" of 18 countries on January 1, 1994. The Agreement involves the acceptance by these EFTA countries of a great part of EC legislation, including the directive on money laundering, which should be implemented into their national law. Therefore, the European Economic Area will be provided with high, harmonized standards to combat money laundering. From January 1, 1995, three of these countries (Austria, Finland, and Sweden) are members of the EC, now called the European Union.

With respect to the neighboring countries in Central and Eastern Europe, even if money laundering is only now emerging there, adoption of preventive measures in this field would impede organized crime from taking root and extending its influence in their territories. Six countries that have signed Association Agreements with the Community—Hungary, Poland, the Czech Republic, the Slovak Republic, Romania, and Bulgaria—have agreed to include specific clauses under which the parties will make every effort to cooperate in order to prevent money laundering and to establish standards equivalent to those contained in the Money-Laundering Directive and in the FATF recommendations. A pilot

cooperation program on drugs, including money laundering, has been set up with these six countries. Furthermore, the European Commission has started negotiating "partnership and cooperation agreements" with the Baltic countries, Russia, and the other countries of the former Soviet Union, which would also cover the field of money laundering. All these provisions will constitute an appropriate framework for cooperation and assistance in this field over the next several years. The FATF will play an important role in coordinating and avoiding overlapping with other countries and international organizations involved in cooperation in this region.[67]

COMMENT

SYDNEY J. KEY

The European Community's Approach of Mutual Recognition and Home Country Control and the Deposit-Guarantee Directive

In creating the internal market in the banking sector, the challenge facing the European Community (EC) was to establish a regulatory and supervisory framework that would promote a competitive and efficient Community-wide market for banking services and also would satisfy other public policy concerns, such as ensuring the safety and soundness of banks and the stability of the financial system and providing adequate protection for consumers of banking services. To establish such a framework, the Community had to choose rules to govern trade in banking services among the member states.

The principle of national treatment, which involves application of host country rules without discriminating between domestic and foreign banks, might have seemed the obvious choice.[1] National treatment is a generally accepted principle for trade in financial services and is used in the General Agreement on Trade in Services (GATS) and in commitments made in the Organization for Economic Cooperation and Development (OECD).[2] If the EC had used national treatment to govern trade in financial services among its member states, foreign and domestic banks would have received equivalent treatment within each member state. However, barriers created by nondiscriminatory differences in national rules would have remained–for example, differences in permissible activities for banks or differences in the types of products that may be offered.

To remove such nondiscriminatory barriers, it was necessary for the Community to go beyond the principle of national treatment. One possible approach, the complete harmonization of national rules, was eliminated because the Community had a history of unsuccessful attempts at complete harmonization in the product sector. Another possibility was to use home country rules. However, without any harmonization, this approach would not have been acceptable to host countries. The Community turned instead to the approach of "mutual recognition."[3]

Mutual recognition involves two elements: first, harmonization of essential rules; and second, where harmonization has not occurred or has occurred only in very general terms, acceptance by host countries of

home country rules. Thus, under the Second Banking Directive, a bank established in any member state may, subject to the minimum requirements set forth in EC legislation, provide services across borders or operate branches throughout the Community under home country rules and supervision.[4]

The Second Banking Directive sets forth a list of permissible activities (which includes all forms of securities activities but not insurance activities), and a host country is required to permit a branch of a bank from any other member state to engage in any activity on the list that is permitted by the home country.[5] For example, an Athens branch of a German bank is governed by German rules for permissible activities, subject to the EC list, rather than by the Greek rules, even if the Greek rules would have been more restrictive.

Within the Community, such reverse discrimination favoring banks from other member states is essentially a strategy to produce additional harmonization and is predicated on political agreement on goals for convergence of national regulatory systems. Such agreement involves a crucial element: a consensus on where to draw the line between liberalization and laxity–that is, a distinction between national rules that have primarily the effect of imposing barriers to trade in services and national rules that are necessary for prudential purposes or for consumer protection.

Once the rules that will be used for trade in banking services have been agreed to, a separate but related question is, Who administers the rules–the home country, the host country, or a supranational entity?[6] This is an important question because the harmonization of capital standards, for example, does not guarantee the quality of supervision. The Community is using home country control, which means that the home country supervisors are responsible for administering the rules.[7]

The shift to home country supervision and regulation of branches of banks within the Community is quite dramatic, especially in comparison with developments outside the Community. For example, in the United States, the Foreign Bank Supervision Enhancement Act strengthened the host country statutory framework that federal regulators must apply in dealing with the entry and operation of branches of foreign banks.[8] Similarly, the Basle guidelines on minimum supervisory standards for international banking emphasize the responsibility of host country authorities, as well as those of the home country.[9] For example, the consent of a host country is required to open a branch of a nonindigenous bank.[10]

The European Community has been able to rely on home country rules and supervision because its harmonizing measures are different

from what has been achieved beyond the Community in two significant respects. First, the measures are legally binding as part of the body of supranational EC law, as opposed to informal agreements among, for example, bank supervisors of the major industrial countries. Second, the harmonization within the Community is much broader than the harmonization that has been achieved beyond its borders, where the major negotiated harmonization of rules involves the Basle Accord on risk-based capital standards, now expanded to include market risk.[11] Besides capital standards, EC banking legislation also deals with matters such as bank ownership of nonfinancial institutions, bank accounting standards, major shareholders and changes in share ownership, large exposures, consolidated supervision, deposit insurance, and, in future perhaps, bankruptcy rules. (A long-standing European Commission proposal with regard to bankruptcy rules for financial institutions has recently been reactivated.) Moveover, harmonizing measures in other areas, such as competition policy and company law, also affect the banking sector.

The Deposit-Guarantee Directive is particularly interesting because it is a hybrid of the home country and host country approaches.[12] It is structured as a home country directive: depositors at branches of a bank from another member state must be covered by the home country deposit protection scheme.[13] Under a complete home country approach, this provision would imply that the home country scheme would determine the level and scope of coverage within the bounds set by Community-wide harmonization. It would also imply that the home country scheme would assume financial responsibility for any payout.

However, the member states were unable to agree on sufficient harmonization of coverage for the complete home country approach to be acceptable. They were able to agree on only a relatively low Community-wide minimum level of coverage, together with a limitation on risk sharing by depositors at low levels of coverage.[14] The member states could not agree on a maximum level of coverage or a requirement for risk sharing by depositors at high levels of coverage.

As a result, the Deposit-Guarantee Directive provides a significant role for the host country with respect to both coverage and financing. In effect, host country rules determine the minimum coverage and also–until the end of a transitional period–the maximum coverage that may be offered to depositors at branches of banks from other member states. The host country scheme also assumes financial responsibility to the extent that host country coverage is higher than home country coverage. As a result of Germany's objections to these provisions (and also to mandatory membership in a deposit protection scheme), the Council's common

position on the Deposit-Guarantee Directive was adopted by a qualified majority, without German support.

The exception to the home country approach that deals with minimum coverage and financing is known as the "topping-up" provision. Under this provision, a host country scheme must offer each branch of a bank from a member state where coverage is lower the option of topping up its coverage to the host country level.[15] For example, the German scheme, which has the highest level of coverage in the Community, must offer German branches of banks from other member states the option of topping up coverage to the German level. A branch would, however, not be required to accept.

The main benefit of topping up is that it contributes to greater uniformity of coverage within a host member state. However, because topping up occurs at the option of the branch, it appears to be designed to reduce competitive distortions rather than to increase consumer protection. Moreover, topping up removes only one source of pressure to increase coverage, namely, competition between low-coverage branches and high-coverage domestic banks. Pressures to increase coverage could still arise because low-coverage domestic banks would be competing with high-coverage branches within a host country.

Topping up reintroduces some of the disadvantages of host country deposit insurance for branches, although in a milder form. Member states preferred a home country approach to deposit insurance primarily because of the shift to home country regulation and supervision of EC branches mandated by the Second Banking Directive. Several member states were particularly concerned about the financial exposure of a host country deposit protection scheme to the risk of inadequate home country regulation and supervision. To the extent that it exposes the host country scheme to this risk, topping up poses a similar problem.

Moreover, topping up could be complicated to administer and confusing for depositors. The directive provides for the establishment of objective, generally applied conditions relating to the membership of low-coverage branches in host country schemes, and an annex sets forth guiding principles for the home country and host country schemes.[16] However, there are likely to be significant practical problems. Issues that could be particularly complicated involve deposits at multiple offices, coinsurance and the scope of coverage, netting deposits and loans, and the implementation of payouts involving more than one scheme.

The exception to the home country approach that deals with maximum coverage during a transitional period is known as the "no export" principle. Under this provision, coverage for depositors at a host country

branch of a bank from another member state is limited to the maximum coverage available under the host country scheme until the end of 1999.[17] Thus, during the transitional period, high-coverage home countries must apply host country rules to determine maximum coverage for EC branches of home country banks. The primary motivation for this provision appears to have been concern by low-coverage banks about their ability to compete with high-coverage branches located in the same market in the absence of a Community-wide limitation on coverage.

In August 1994, the German Government filed a complaint with the Court of Justice of the European Communities, contending that the no export provision violates the EC Treaty.[18] This dispute emphasizes the need for an EC directive to establish the maximum level and scope of coverage. However, a Community-wide limitation on coverage was considered politically impossible, primarily because of Germany's strong opposition.

The German complaint also challenges the topping-up provision.[19] Some experts who had previously questioned the no export principle nonetheless suggested that topping up did not present the same legal difficulties because topping up occurs at the discretion of each branch. However, if the branch exercises the topping-up option, the host country is required to provide insurance coverage, even though the home country has responsibility for regulating and supervising the branch. This situation highlights the importance, as well as the difficulty, of achieving sufficient Community-wide harmonization of coverage to make the use of home country rules acceptable to the member states.

The approach of mutual recognition was used in other EC directives to achieve convergence of national regulatory systems. As previously discussed, although the Community did not require member states to allow banks to engage in activities listed in the Second Banking Directive, it created a situation in which market forces would be likely to lead to regulatory convergence with regard to the listed activities. For deposit insurance, however, it does not seem desirable to use the market behavior of bank customers to pressure national governments for the convergence of rules that have not been completely harmonized. There was a consensus within the Community regarding the activities on the list of the Second Banking Directive. In effect, the list was an explicitly agreed-upon goal for convergence. However, no such consensus exists for raising the levels of deposit insurance above the relatively low minimum level imposed by the Deposit-Guarantee Directive or that doing so would be worth introducing more distortions into the marketplace.

Limiting coverage by setting a Community-wide maximum level of coverage or by requiring depositor coinsurance above the Community-

wide minimum level of coverage would reduce moral hazard and the magnitude of potential competitive distortions. These steps would not, however, address the underlying issues of pricing and subsidization in deposit protection schemes, which the Community did not attempt to deal with through the directive.

It remains to be seen how the Deposit-Guarantee Directive will work in practice. Any deposit protection scheme must address the problem of balancing conflicting policy goals. The goals of protecting depositors and reducing systemic risk argue for relatively comprehensive levels of coverage. The problem is that, in furthering these goals, deposit protection schemes may encourage banks to take excessive risks–the problem of moral hazard–and thereby tend, perversely, to undermine the safety and soundness of banks. Subsidies in deposit protection schemes may also introduce distortions into financial markets. Thus, the goals of reducing moral hazard and avoiding competitive distortions argue for a minimalist approach to deposit insurance.

Striking a balance between competing public policy concerns was particularly difficult for the EC because doing so involved trying to reach agreement among member states with deposit protection schemes that differed significantly. The Community had little choice but to adopt a home country deposit protection directive because, in light of the shift of authorization and supervision of EC branches from the host to the home country, the previous arrangements for deposit insurance were no longer acceptable to the member states. However, because of the absence of political agreement on sufficient harmonization for a complete home country approach, the Deposit-Guarantee Directive ended up as a hybrid. Experience will show whether adopting the topping-up provision and imposing a transitional host country limitation on coverage are adequate substitutes for the more extensive harmonization that would have been required to have a complete home country approach.

Finally, it is important to keep in mind that deposit insurance is only one element of the safety net. As a result, even if there were much greater harmonization of deposit protection schemes among the member states, differences in the overall protection that countries offer depositors would still exist. The reason is variations in other features of the safety net: "too-big-to-fail" policies; government ownership of banks, with its implicit guarantee; and potential government support for publicly or privately administered deposit protection schemes in times of crisis. In practice, differences in these other elements of the safety net could be more important than differences in deposit protection schemes per se. Of course, for all banks, the first line of defense in protecting consumers and reducing systemic risk is prudential supervision and regulation, including strong

capital standards. Deposit protection and other elements of the safety net come into play only after measures designed to deal with safety and soundness have failed.

Chapter

8 GATT and Its Effect on Banking Services

KATHLEEN M. O'DAY

Introduction

The General Agreement on Tariffs and Trade (GATT) and the agreements that were concluded as part of the Uruguay Round are trade agreements. This chapter provides the background on why the Board of Governors of the Federal Reserve System, together with other U.S. regulators, thought it important to be involved in the actual negotiations on the agreement relating to trade in services. The chapter then briefly describes the main features of the General Agreement on Trade in Services (GATS) as it relates to financial services.[1] Finally, the implications of the GATS for banking services and, just as important, the implications for regulators and central banks are addressed.

Issues Arising in the GATS Negotiations

As part of the Uruguay Round, an attempt was made for the first time to bring trade in services within a multilateral agreement, in order to achieve greater liberalization than currently exists in the services sectors. The agreement sought greater access to local markets for foreign firms and the provision of national treatment to foreign firms operating in local markets.

The services sectors are very important in the United States. The United States has a policy of encouraging openness in its sectors. Also, the Federal Reserve always has supported greater market access in other countries for U.S. banks. However, trade in financial services was viewed by the Federal Reserve as a unique sector with special aspects that could raise issues in the context of a multilateral trade agreement.

There were three major areas of concern. First, any agreement covering financial services should take adequate account of a country's right to protect its banks, the depositors, and the financial system generally.

Second, unlike other types of agreements to which the United States is a party, such as that establishing the Organization for Economic Cooperation and Development, the GATS has an enforcement mechanism

for its provisions.[2] The Federal Reserve's concern has been to ensure that the panelists in the dispute settlement system who will decide whether the United States is abiding by the obligations of the agreement will be experts in the area of financial services, and not necessarily trade specialists. The traditional GATT practice has been to maintain a roster of potential panelists for settling disputes. Naturally, in settling a trade dispute, trade specialists are needed; however, financial experts should also staff the panels in disputes involving financial services.

The third area of concern arose from the traditional GATT practice in trade in goods of allowing countries to retaliate for violations of the agreement (although not necessarily in the same sector as the violation). If this practice were extended to financial services, retaliation against a bank could, for example, disrupt the financial system. In addition, trade in banking has achieved a significant liberalization over the years, and the United States did not want, in effect, to settle for something that did not create as much liberalization as bilateral agreements may already have provided. Therefore, the Federal Reserve believed that cross-sectoral retaliation for violations of a potential agreement on financial services should not be permitted.

Many aspects of the implementation of the GATS, especially regarding how disputes are settled, must still be worked out through the World Trade Organization. However, important protections in the agreement were achieved only because the finance ministries and regulators of many countries fought for recognition of the special nature of financial services that should be taken into account in devising a system of multilateral obligations.

Main Features of the GATS

Major Obligations

What are the obligations of members of the GATS? First, the concept of "most-favored-nation"[3] applies to the measures of a party, where "measure" is defined as any element within a country, including laws, regulations, and administrative practices, that affects a firm's legal ability to provide a service.[4] The most-favored-nation provision requires that a member of the GATS provide most-favored-nation treatment to any other member of the GATS with respect to any of the former's laws and regulations.[5]

Two major obligations in the GATS are intended to achieve the goal of greater market liberalization—market access[6] and national treatment.[7]

In accepting the obligation of market access, a country liberalizes its laws so that foreign firms are able to enter and compete in the domestic market. Once they enter and begin to compete, the obligation of national treatment requires that these firms should be treated no less favorably than domestic firms in the same circumstances.

These are noble goals. However, there is no obligation to provide complete market access or full national treatment in this round of the GATS. As a result, countries are able to decide for themselves how much they want to liberalize their market access. The agreement requires countries to list the commitments that they are willing to make.[8] Therefore, either they can be very liberal, by listing many areas that are open to foreign firms and providing full national treatment, or they can make no changes at all in their current laws. The agreement itself creates no new liberalization; it is only what the countries are willing to give that allows the purpose of the agreement to be achieved.

In addition to being able to choose how open it will be, a country can also protect its existing discriminatory laws under the GATS.[9] If there is a law on the books that allows a country to give a benefit to a domestic bank while withholding that benefit from a foreign bank, the country can protect that law. In effect, it takes a reservation from the obligations of the agreement. This is another area about which the U.S. trade negotiators had a concern; this is why there is still much negotiating to be done on financial services. Again, the agreement itself does not achieve the liberalization. Each country must do that on its own. It is then up to each country to decide whether it will enter into an agreement on services, based on the amount of liberalization that has been achieved generally through the Uruguay Round.

Finally, the GATS provides for settlement of disputes.[10] If one country feels that another country is not abiding by the obligations of the agreement, a mechanism allows the former country to bring its case to a panel of experts, who will decide whether the offending country is, in fact, living up to its obligations. The GATS provides many details on how the panels are to be selected. Although the finance ministries and the regulators were very interested in establishing a separate body that would look solely at disputes in financial services, this goal was not achieved. A Council on Trade in Services is to be established within the new World Trade Organization, but there will not be a separate financial services body.[11] However, it is required that, in a dispute relating to financial services, the panel be staffed with financial experts.

These major obligations of the GATS apply to all 17 services sectors,[12] including the financial services sector. However, because of the view that financial services are particularly unique, an annex was created to further

explain and elaborate on the requirements of the agreement with respect to financial services.[13]

Annex Requirements

The most important of the financial services annex requirements relates to the roles of supervisors, regulators, and central banks. First, services that are provided cross-border or through the establishment of a presence in another country[14] must be dealt with according to national treatment, in line with the goal of the GATS.[15] However, services supplied in the exercise of governmental authority are not covered by the obligations of the agreement.[16] It is important for supervisors and central banks—and certainly for the Federal Reserve—that the conduct of monetary policy or exchange rate policy be considered to be governmental and therefore not subject to the obligations of the agreement.[17] Because of this provision, therefore, the Federal Reserve is not obligated to try to ascertain beforehand whether its monetary policy in some way creates a barrier to market access or violates the obligation of national treatment.

Second, the financial services annex contains a most important provision, a so-called prudential carve-out[18] or prudential exception. This stipulates that a country is not prevented from taking measures for prudential reasons, that is, for the protection of investors, depositors, or policyholders, or for the stability of the financial system. This provision is very important because, prior to the involvement of the regulators and the finance ministries in the negotiations, the regulation of financial institutions—and banks in particular—was viewed to some extent by trade specialists as a barrier to trade. They considered that excessive regulation would prevent entry by some firms that would not be able to meet the standards of prudential regulation. Therefore, the trade specialists were not sympathetic to the idea that some kind of special protection should be provided for the regulation of financial services.

However, it was felt to be important enough by the regulators (and by the Department of the Treasury in the United States) that the United States was able to make the case that, in fact, financial services were unique. Regulators must be able to regulate for prudential purposes, without fear that they will be involved in a dispute settlement every time that they do something that may have an impact on a foreign firm.

Another aspect of the financial services annex recognizes cooperative arrangements.[19] It is becoming more prevalent for supervisors to work out agreements between each other to, in effect, recognize the prudential system in the home country and therefore not apply certain aspects of the host country regulation to activities in the host country. For example,

the U.S. Securities and Exchange Commission has effectively recognized that the investor disclosure requirements of Canadian law are sufficient to meet the prudential requirements of the United States. Similarly, Canada has determined that the U.S. disclosure requirements are sufficient for Canadian purposes. Because of this cooperative arrangement, therefore, companies in the United States and Canada that wish to issue securities in both markets can use the same disclosure material.[20]

It is important that the financial services annex sanction this kind of agreement; otherwise, an agreement concerning investor disclosure requirements could be accused of violating the most-favored-nation obligation. By recognizing Canada, for example, it might be argued that the United States was discriminating against other countries. The financial services annex, however, recognizes that cooperative arrangements are an appropriate prudential tool for regulators and that entering into these kinds of agreements is consistent with the obligations of the GATS.

The framework agreement applies to all of the services sectors and establishes the general obligations of the GATS, while the Annex on Financial Services takes into account the unique nature of financial services by providing for prudential exceptions and allowing regulators to continue to work together to establish cooperative arrangements. However, nothing discussed so far obligates any country to liberalize its markets now. Some countries, including the United States, argued strenuously—but unsuccessfully—during the long negotiation process for a more comprehensive agreement on financial services that would establish significant additional obligations that go beyond the general obligations of most-favored-nation, market access, and national treatment. However, remnants of the idea that the agreement should actually require some liberalization remain, including, for example, the Understanding on Commitments in Financial Services.[21] The function of an understanding is to allow a country to commit itself to greater market-opening commitments than are contemplated by the general framework. For example, if the United States were to decide to abide by the Understanding on Commitments in Financial Services, it would have to list all market monopolies operating in the country.[22] Furthermore, it would have to commit to endeavor to eliminate those monopolies.[23] Another example is the auto insurance systems that some provincial governments in Canada operate as monopolies. If Canada were to choose to abide by this understanding, it would have to list those systems as monopolies in its commitments and try to remove them over time, thereby allowing other services providers to come in and sell auto insurance.

By agreeing to abide by the Understanding on Commitments in Financial Services, a country must allow certain cross-border activities.[24]

It must, for instance, allow the provision of new financial services, which would enable foreign firms to introduce innovations into a market on a national treatment basis.[25] A country must also allow the cross-border processing of data, as well as a number of other items.[26] It is not clear yet how the understanding will relate to the obligations under the framework and the financial services annex. However, it is one route whereby some countries might choose to enlarge market access and make stronger national treatment commitments.

To some extent, the GATS is a complicated entity. It gives countries a choice of how they want to be regulated under the agreement: they can abide by either the framework and the annex or by the framework, the annex, and the understanding.

Implications of the GATS for Banking Services

What are the implications of the GATS for banking services? First, the GATS might actually achieve its goal of liberalizing markets. Countries may make commitments to give greater market access. Banks may be able to operate in new markets, bringing innovations in financial services where these innovations were not previously available. This liberalization may occur, but there is no guarantee that it will. The initial progress made in achieving market liberalization in financial services was disappointing. For that reason, the negotiations on financial services were scheduled to continue for many months. If liberalization is not achieved, there may be some movement to establish bilateral reciprocity arrangements, in which countries try to achieve on a bilateral basis what is unavailable in the GATS. This movement is apparent in the United States, where there is pressure to adopt the Fair Trade in Financial Services Act.[27] This pressure is being brought to bear precisely because it is felt that little progress has been made in the last few years, and certainly not in connection with the GATS.

Second, it is fair to say that banks will probably not be affected by this agreement one way or another in their day-to-day operations. They may get to enter the markets of additional countries. However, the GATS did not achieve a breakthrough in making available new banking services; it merely provides the opportunity to bring existing services to other markets.

The third and greatest implication may actually be for bank regulators. In carrying out their duties, regulators must now be careful to abide by the national treatment and most-favored-nation obligations of the GATS. A very important protection has been established for them in the financial services annex—the prudential exception. However, their prudential

decisions relating to regulation will be subject to challenge. A regulator's decision may be viewed as a discriminatory and not a prudential measure. Regulators must be prepared to defend themselves, if necessary, in dispute panels. For this reason, central banks and regulators, in making their decisions affecting foreign banks operating in their markets, must be careful to justify their decisions as consistent with the national treatment and most-favored-nation obligations. If central banks and regulators are not consistent in upholding those obligations, they must be able to demonstrate that their actions, in fact, have been taken for valid prudential reasons.

For better or worse, banking and other financial services are now subject to a trade agreement and to trade disciplines. Much work remains to be done under the GATS and other parts of the Uruguay Round; that work will presumably occur in the establishment and workings of the World Trade Organization, which, naturally, will be run by trade specialists. Central banks and supervisors, however, should continue to exercise vigilance to ensure that trade specialists recognize the unique nature of financial services. Central banks and supervisors should continue to concern themselves with how trade agreements are structured, in order to be able to regulate prudently in the interests of depositors and the stability of the financial system. Furthermore, they should seek to influence any future agreements in this area, as well as decisions interpreting the prudential exception provision.

COMMENT

MARILYN L. MUENCH

Today, there are few hard-and-fast conclusions that can be drawn about the manner in which the General Agreement on Trade in Services (GATS) will affect financial services.[1] If it is implemented in the manner that the drafters were considering while working on it, the specific commitments made in financial services and the general obligations undertaken should not interfere with the ability of banking and other financial services regulators to do their jobs. Moreover, there should be no interference with the activities that central banks traditionally undertake. This comment provides an idea of the context in which agreement on financial services was reached by addressing three questions: How was the final product created? Why does the agreement look the way that it does? What happens now?

Forming a Consensus on the GATS

The story of the GATS goes back a number of years. Liberalization in trade in goods has been fostered since 1948 by the General Agreement on Tariffs and Trade (GATT). There was a growing recognition, however, that the GATT, limited as it was to merchandise trade, either did not cover, or covered inadequately, some very important areas, including agriculture, intellectual property, and, in particular, services. In the mid-1980s, it was decided to launch the Uruguay Round in Montevideo, Uruguay, as a means of dealing with these new areas. The choice of Uruguay, incidentally, was made to emphasize the growing importance and participation of the developing countries. The Uruguay Round was to have concluded in December 1990; it did not.

Although work on the GATS began in late 1986, the United States was a little slow in contributing to the efforts being made in the financial services area. The Department of the Treasury, at least, did not really get involved in the work that was under way until 1989. By then, a draft agreement on trade in services, which greatly resembled the GATT, had been prepared. In this draft, the word "services" was substituted for the word "goods," although the draft had, of course, no tariff provisions. It did have a most-favored-nation provision and dispute resolution provisions, as well as a balance of payments section.

For the United States, a big concern was the need to recognize in the final agreement that the field of financial services was highly regulated. Financial services have special characteristics that need to be taken into account and, in some cases, protected. The idea was not just that financial services were neither a good, like a widget, nor a commodity, like soybeans. It was also that the field of financial services was not really like any other service: it was not tourism, it was not accountancy, it was not legal services. U.S. financial service experts therefore began meeting in Geneva with financial services experts from other countries in the hopes of finding some common ground.

One overriding interest and common concern was found: the ability of regulators to regulate on prudential grounds needed to be protected. The financial services experts were able to unite behind this goal, and the drafters began to develop what became known as the prudential carve-out provision.[2] Also, the drafters agreed that it was important that financial services experts should oversee the functioning of the GATS as it applied to financial services. To that end, they took steps to ensure that financial services experts would be represented on dispute resolution panels involving financial services.

By the end of 1990, the scheduled completion of the Uruguay Round was approaching. Almost all countries, including the United States, had accepted the idea of appending a financial services annex to the GATS as an integral part of the overall agreement,[3] in order to address the special concerns of financial services. However, the contents of the annex were still very much in dispute.

Modalities of the GATS

The Uruguay Round did not conclude in December 1990. Although most of the publicity at that time focused on disagreements in the agricultural area, there were many unresolved issues in other areas, including financial services. The main outlines of the agreement, however, had been reached. The GATS would provide the general framework of principles for all services. There would be sectoral annexes, including one for financial services covering the special needs of that particular sector.[4] Finally, it was agreed that each country would prepare its own schedule, setting forth its commitments to market access and national treatment. These schedules would become part of the overall agreement as well.

No country was obliged to take on any particular commitments with respect to the principles of market access or national treatment. These matters were totally voluntary. As originally conceived, they were to be achieved through a series of bilateral negotiations, in which one country

would make a request of another country, which, in turn, would respond with a counteroffer.

By the end of 1991, one year past the deadline, there was great pressure on all the parties finally to work out the remaining GATS issues through compromises and imposed solutions. The main documents remained as they were, with the addition of the Understanding on Commitments in Financial Services.[5] The understanding basically set forth more-detailed obligations that some of the industrial countries wanted to undertake.

Many things came together at the end of 1991. One of the most important was reaching agreement for the first time on the establishment of a World Trade Organization. The concept was to have one institution that would undertake implementation of a broad spectrum of major agreements: the GATT, as updated; the GATS; an intellectual property agreement; and, finally, a new and expanded dispute resolution agreement. Unfortunately, agreement could not be reached on the treatment of agricultural products. Therefore, the talks did not end in 1991.

In 1992, further discussions were held, but no real progress was made. This was partly because other countries were not sure whether there was going to be a change in U.S. policy following the presidential election.

Early in 1993, however, two important events occurred in the United States that affected the completion of the Uruguay Round. First, the new Administration made clear its commitment to finish the Round. Second, the so-called fast-track procedures for dealing with trade agreements were extended to December 15, 1993.[6] Fast-track procedures are a legislative device that allows the U.S. Congress to consider trade agreements under special rules that limit debate and amendments. The extension of fast-track procedures thus provided one impetus for finally concluding the talks. Another impetus was the general weariness felt after nearly seven years of Uruguay Round negotiations. Therefore, December 15, 1993 was set as the final date for completing the Uruguay Round. Negotiations came right down to the wire. After negotiating all of the prior evening and into the early hours of December 15, participants were able to strike a compromise on financial services as part of the nonstop negotiations that managed to achieve agreement on a number of difficult issues. It was also agreed that the negotiations on financial services would continue until no later than six months after the Uruguay Round agreements entered into force.

The United States was one of those countries that believed that the financial services negotiations should be extended. The U.S. Administration had been concerned, as had the Congress and U.S. indus-

try, about "free riders," countries that were seen as benefiting from the agreement without necessarily contributing their fair share. The problem arose because the most-favored-nation provision of the GATS meant that any commitment that a country put into its schedule applied automatically to any other signatory, regardless of the level of commitments made by that signatory. Because of its feeling that financial services should be further liberalized by all countries, the United States, as was permitted, took a broad exemption from the most-favored-nation obligation, as did several other countries.

Future of the GATS

The final act embodying all of the results of the Uruguay Round was signed on April 15, 1994 in Marrakesh, Morocco.[7] The Uruguay Round agreements entered into effect on January 1, 1995.

The compromise on financial services adopted in December 1993 also entered into effect on January 1, 1995. Under the compromise, those most-favored-nation exemptions that were dependent upon the level of commitments made by other countries were suspended; other most-favored-nation exemptions, however, remained in effect.

The broad most-favored-nation exemption of the United States was thus suspended during the first six months after entry into force. At the end of the six months, every country would have the right to evaluate all the commitments that it made with respect to financial services in light of the commitments that other countries were making, and also to re-evaluate and finalize its most-favored-nation exemptions.

Financial services negotiations continued through June 1995. Additional commitments and clarifications from other countries are being sought. An extraordinary amount has been accomplished since the launching of the Uruguay Round in 1986, and the general trend of liberalization and investment is beginning to extend to financial services. The United States continues to hope that the inclusion of financial services in the GATS will provide benefits by expanding the availability of financial services without harming the ability of regulators to ensure that these services are provided in a prudent and appropriate manner.

Chapter

9 The Implications of NAFTA for Central Banks

KEITH A. PALZER

Introduction

The topic to be discussed in this chapter is the legal issues arising for central banks under Chapter Fourteen of the North American Free Trade Agreement (NAFTA).[1] The discussion is a brief primer for lawyers engaged in financial services negotiations or advising on the regulation of financial services, particularly banking services, where NAFTA is applicable. This discussion may be viewed in light of the recent initiatives by the United States to seek further liberalization of financial services in Asia, Latin America, and other emerging markets of the world. It is intended to promote consideration of NAFTA, rather than to serve as a comprehensive explanation of NAFTA provisions. Those interested in the particulars of NAFTA should refer to the agreement itself or to the U.S. Government's summary of NAFTA, which is included as part of the implementing legislation.[2]

The discussion below is divided into three sections. The first section considers how the NAFTA legal regime governs banking services and banking regulations. The second section briefly examines how NAFTA might promote integration in the financial sectors of NAFTA countries. The third section briefly discusses the balance of payments implications of NAFTA, particularly through its interface with the International Monetary Fund's Articles of Agreement. Finally, the chapter discusses some matters of interest for central bank lawyers.

NAFTA Rules Governing Banking

Overview

NAFTA covers two types of activities in financial services: investment in financial services and cross-border trade in financial services. Generally speaking, the rules governing financial services investment are more developed in NAFTA than those governing cross-border financial services, so making this distinction is important.

Investment in financial services is defined under NAFTA as investment in a "financial institution."[3] The term "financial institution" is defined as a company that offers financial services and is regulated as a financial institution under the laws of the country in which it is located.[4] The investment rules under NAFTA govern both the actual making of an investment in a financial institution and the treatment by a NAFTA government of a financial institution that is owned or controlled by nationals or companies from another NAFTA country. Cross-border financial services, in contrast, are defined under NAFTA as the provision of financial services by a person located in the territory of one NAFTA country to a person located in another NAFTA country.[5]

It is interesting to note that the NAFTA rules governing banking services are similar to the rules governing financial services under the General Agreement on Trade in Services (GATS),[6] even though NAFTA's entry into force predates the entry into force of the GATS. This is because Canada and the United States were among the more active delegations in negotiating the GATS provisions from 1986 until 1991.[7] By the time that the NAFTA negotiations formally began in June 1991, the GATS rules were relatively settled, thus accounting for the similarity in policy goals and drafting of the two sets of provisions. One should be aware of these similarities when interpreting or applying either of the two agreements.

There are five basic obligations in NAFTA that govern financial services, as well as three supplementary rules and a number of general exceptions. This section will analyze each of these sets of provisions in turn, in order to survey the basic issues that a central bank lawyer might confront under NAFTA. In addition to honoring these provisions, each country may lodge "reservations" and invoke exceptions to the five basic obligations. These reservations and exceptions allow the member country to continue to enforce laws that are contrary to the legal rules on either a permanent or transitional basis. Transitional rules allow a country to conform over time its domestic laws that are contrary to the basic obligations.

Basic Rules Governing Financial Services

The five basic rules of NAFTA that govern financial services are rules affecting

- national treatment;[8]
- cross-border trade in services;[9]
- most-favored-nation treatment;[10]
- new financial services and data processing;[11] and
- senior management and boards of directors.[12]

National Treatment

National treatment under NAFTA, like that in the GATS, looks at the treatment that a government provides a foreign firm and asks whether it is "no less favorable" than that provided by the government to a similarly situated domestic firm.[13] If it is less favorable, a reservation or exception must cover that treatment; if no reservation or exception applies, the discriminatory treatment will be considered to be a violation of NAFTA. Violations of NAFTA's basic rules can result in the sanctioning of a government under the NAFTA dispute settlement procedure commenced by one member government against another member government.

The national treatment obligation is a cornerstone of the agreement, and much debate will likely focus on the addition of language in the obligation requiring "equal competitive opportunities" to be accorded to foreign persons.[14] As a legal matter, this language comprises the concept of de facto national treatment, as opposed to the more technical concept of de jure national treatment. Under de facto national treatment, seemingly similar treatment of foreign and domestic firms will not be acceptable if in fact the result is a more burdensome treatment of the foreign firms.

Cross-Border Trade

The cross-border trade obligation under NAFTA is complex.[15] There are two components of this rule: the first covers cross-border financial services that are provided on a solicited or fully serviced basis, and the second governs unsolicited transactions. Unsolicited transactions are sometimes considered to be transactions that are initiated by the purchaser of the service rather than the provider. In practice, it will be very difficult to distinguish between unsolicited and solicited transactions once they have been undertaken; it may thus be easier to distinguish between the two types of transactions by focusing on the degree of publicity, marketing, and servicing on the part of the nonresident financial service provider to determine whether a transaction is solicited or not.

Restrictions on solicited cross-border transactions under NAFTA are subject to a "standstill" commitment. Under the standstill obligation, further liberalization of solicited transactions need not occur under NAFTA, but no NAFTA government may become more restrictive than it was when NAFTA entered into force. Thus, under NAFTA, Mexico, Canada, and the United States must continue to permit cross-border loans denominated in foreign currency, provided that none of the exceptions or reservations permissible under NAFTA come into play.

For unsolicited cross-border transactions, in contrast, NAFTA requires each NAFTA government to permit persons located in its territory to purchase such financial services. Thus, a consumer in a NAFTA country is free under NAFTA to seek out, either electronically or physically, financial services for delivery. As it is extremely difficult for any economy in today's world to prevent its citizens from going abroad and purchasing financial services on an unsolicited basis, this obligation is of questionable value.

Most-Favored-Nation Treatment

The third general obligation under NAFTA is the most-favored-nation obligation.[16] This provision is fairly straightforward, requiring each NAFTA government to provide no less favorable treatment to persons of another NAFTA country than is provided to persons of any other NAFTA or non-NAFTA country. Honoring this obligation will ensure that future treatment exceeding NAFTA standards is always accorded to NAFTA firms. The provision is not, however, intended to prevent NAFTA countries from offering better treatment to non-NAFTA countries, based on regulatory cooperation or recognition arrangements or harmonization. Thus, bank regulators of a NAFTA country can provide better treatment to a non-NAFTA country than another NAFTA country if regulations provide an extra degree of regulatory safety to non-NAFTA firms.

New Financial Services and Data Processing

The fourth general obligation under NAFTA is the new financial services and data processing obligation.[17] This obligation seeks to protect certain competitive advantages that Canadian and particularly U.S. financial services providers have as active international players utilizing innovation and central data processing facilities.

The first paragraph of the article describing this obligation[18] permits a firm from one NAFTA country to offer through its office in another NAFTA country (the host country) any financial service that is permitted in the NAFTA territory if that service is not already offered in the host country. For example, J.P. Morgan, a U.S. bank, received authorization toward the end of 1994 to begin operating a subsidiary office in Mexico during 1995. Unless one of the exceptions under NAFTA applies, J.P. Morgan, a leader in currency derivatives, would be entitled to invoke the new financial services obligation to allow it to offer U.S. dollar-hedging derivatives in Mexico, even if Mexico did not permit such derivatives to be offered by domestic institutions.

The second paragraph of the article describing the new financial services obligation concerns data processing.[19] This provision allows, for example, offices of a NAFTA firm located in a host country to transmit data back to its home country for processing. An important issue to consider under this provision is whether bank secrecy laws would be affected by this obligation. Presumably, a host country would be permitted to require that the data be encoded or protected in another form.

Senior Management and Boards of Directors

The fifth basic rule in the NAFTA financial services provisions is the senior management and board of directors obligation.[20] There are two parts to this obligation. First, no NAFTA country can impose more than a simple majority requirement of citizenship for the boards of directors of its financial institutions.[21] For example, although the United States can require that a portion of an 11-member board of a Mexican bank established in the United States be U.S. citizens, it may not require more than 6 members to be citizens. Second, the imposition of a nationality requirement for senior management is prohibited.[22] A nationality requirement, however, does not include residency.

Supplementary Rules

In addition to the five basic rules, three supplementary rules under NAFTA apply to financial services. These rules, which cannot be subject to reservations, are transparency,[23] free transfers,[24] and the rule against expropriation.[25]

Transparency

The transparency obligation requires the regulators of a NAFTA country to provide "to the extent practicable" advance notice of regulations imposed in the financial sector.[26] In addition, each NAFTA government must process a "completed application" within 120 days of receipt.[27] This provision's liberalizing effects may be minimized owing to the flexibility that regulators will have to claim that an application is not completed or that advance notice is not practicable.

Free Transfers

The second supplementary rule is the free investment transfers obligation. This obligation, incorporated by reference into Chapter Fourteen of NAFTA, basically requires a country to permit inbound and outbound transfers of currency in support of financial investment.[28] Recapitalization

of investment, repatriation of dividends or liquidations, and currency transfers to facilitate any business of a foreign-owned financial institution in the host country would all qualify as investment transfers.

Rule Against Expropriation

The third supplementary rule is the rule against expropriation.[29] This rule, similar to the free transfers rule incorporated by reference from the investment chapter of NAFTA, is important because it resolves an important North American jurisprudential debate. Earlier this century, the Mexican Government expropriated the properties of a number of U.S. and other countries' oil companies. In the expropriation cases and controversies that transpired in connection with these cases under international law, the Mexican Government asserted two particular arguments that, if accepted, would have the effect of minimizing its liability for the expropriations.

The first argument is the so-called Calvo Doctrine, which prohibited a foreign corporation from seeking the assistance of its home government in a dispute over the investor's rights with the host government. The second argument concerned the valuation of an expropriated investment. The Mexican government argued that the true valuation of expropriated property was the fixed asset value of the property, rather than the going-concern value of the enterprise (including projected revenue streams from a particular investment or from the granting of drilling rights).

NAFTA resolves these two investment debates either directly or indirectly. With respect to the Calvo Doctrine, NAFTA permits an investor to involve a host NAFTA government in an international dispute settlement procedure for violations of either the expropriation or free transfers article.[30] Alternatively, a NAFTA government can commence a formal proceeding under NAFTA against a host government accused of expropriation. The valuation debate is resolved by NAFTA because the expropriation article requires that an investment subject to expropriation by a NAFTA government be compensated for by that government, taking into account the going-concern value of the investment.[31]

Reservations and Exceptions

Reservations

Reservations under NAFTA are specifically listed derogations by individual countries from any of the five basic obligations of NAFTA.[32] Reservations, which, for example, can be lodged for laws that are of particular political importance to a country, must be negotiated on a case-

by-case basis. Reservations can be lodged against only the five basic rules of NAFTA—and not against the supplementary rules of Chapter Fourteen.

Exceptions

NAFTA also permits a country to invoke exceptions from its Chapter Fourteen provisions.[33] Exceptions (as opposed to reservations) are drafted so that any country can invoke them. Similar to the GATS, there are two important exceptions: an exception for reasonable prudential financial regulation;[34] and an exception for the implementation of nondiscriminatory monetary policy.[35] The NAFTA exceptions are, however, drafted a bit tighter than the GATS exceptions.

The first prudential exception states that no provision of Chapter Eleven (the general investment chapter), Chapter Twelve (the general cross-border services provision), Chapter Thirteen (governing monopolies), or Chapter Fourteen (on financial services) shall be construed to prevent the application of "reasonable" measures taken for prudential reasons.[36] One of the interesting questions presented by the drafting of this exception is how the word "reasonable" should be applied by dispute settlement panels. For instance, a panel might decide whether a measure is "reasonable" by reviewing the possible policies behind the measure and the actual effects of the regulation. A balancing test might be used, as was done in a number of panel rulings regarding exceptions for trade in goods disputes under the General Agreement on Tariffs and Trade, whereby the trade-limiting effects of a measure would be balanced against the interests of trade liberalization. Alternatively, a measure might be judged as to its reasonability according only to the stated purposes of the measure. In any case, the choice of the word "reasonable" will likely be the subject of debate in panel proceedings and have some effect on the overall value of NAFTA as a liberalizing instrument in financial services.

The second major exception under Chapter Fourteen of NAFTA is for nondiscriminatory monetary policy. Nothing in Chapters Eleven through Fourteen shall be construed to prevent a country from applying nondiscriminatory monetary policy and exchange rate measures.[37] Here, too, interpretive issues are present. Assume that a country has a strong foreign presence in its market, with most of the foreign banks engaged in profitable trade finance business. Assume further that the country's central bank restricts trade finance loans by all banks, in possible contravention of the cross-border trade and national treatment provisions of NAFTA. In such a case, it could be argued that the central bank could not rely on the monetary policy exception because of the disparate impact of the measure upon foreign banks.

In addition to the above two exceptions, there are two minor exceptions to Chapter Fourteen. The first exception allows restrictions on free transfers for affiliate transactions that are prudential in nature.[38] Although this provision is arguably redundant in view of the broader prudential exception discussed above, the negotiators felt that the risk of a challenge to prudential affiliate transaction restrictions was serious enough to justify explicit mention.

The final exception allows discrimination against foreigners involved in the privatization of government monopolies in social security services.[39] This political exception was made because the Canadian Government has a number of monopolies in the social security system that may be privatized; the assets of these monopolies, it was felt by the negotiators, should reasonably be limited to domestic ownership at the initial privatization.

Dispute Settlement

A variety of NAFTA provisions come into play for settling disputes concerning Chapter Fourteen.[40] A financial services dispute can be litigated under NAFTA in two basic ways: the state-to-state dispute settlement procedures (governed by Chapters Fourteen and Twenty), and the investor-state dispute settlement procedures (governed by Article 1415 and Chapter Eleven). In this way, NAFTA differs significantly from the GATS because under the latter agreement only the state-to-state procedures are possible.[41]

State-to-State Dispute Settlement

Under the state-to-state dispute settlement procedures of NAFTA, any of the basic or supplementary rules governing financial services can be litigated between countries. Each dispute will likely be decided by members of a panel selected from two standing groups of experts: a financial services roster and a roster of general experts.[42] Rules governing the appropriate mix of general and financial experts essentially ensure that finance experts will be involved in important financial services questions.[43] This would be especially important when the prudential carve-out is invoked.

The state-to-state procedure is designed to promote a settlement of the dispute prior to a formal ruling of the panel. Once a NAFTA government feels that its nationals have been wronged under NAFTA, that government (the petitioner) can commence a long series of diplomatic and legal maneuvers to bring the host government (the respondent) to an international panel, which could ultimately issue a ruling against the respondent.

The process begins with a consultation by the NAFTA governments over the issue.[44] Although not formally required by the text, it is likely that the consultation would be conducted by the Financial Services Committee set up under NAFTA, comprising officials from the finance ministries of all three NAFTA countries.

If these informal consultations do not resolve the issue, a formal consultation phase can be invoked to continue the process.[45] This consultation occurs between both financial and trade authorities of the countries involved. If those formal consultations do not result in a satisfactory resolution within a specified time period, a dispute settlement proceeding can be commenced by either party.[46] After the panel has been selected, the litigants prepare briefs, and oral arguments are held. After the briefings and oral arguments, the dispute settlement panel issues a preliminary finding to both parties, either of which can then file an additional brief. Further oral arguments may also be held. After this second round of briefs, the dispute settlement panel issues a final ruling. Various minimum time limits are set forth in the NAFTA dispute settlement procedures, but these may be exceeded with agreement of the parties.

The final ruling of a state-to-state dispute settlement panel is not itself legally binding under NAFTA. This ruling may be accepted or ignored by the NAFTA parties as they see fit. If, however, the respondent is found to be in violation of NAFTA and chooses to continue the wrongful actions, the petitioner may retaliate by withdrawing benefits under NAFTA (that is, by derogating from NAFTA in a proportional manner in order to convince the respondent to conform with the agreement).[47] This retaliation, however, can occur only within the financial services sector when financial services disputes are involved. In other words, while violations in the financial services sector under the GATS can be remedied by retaliation in other sectors (and vice versa), this option is not possible under NAFTA.

Investor-State Dispute Settlement

The investor-state dispute settlement procedures under Chapter Fourteen are generally available only for violations of the free transfers or expropriation provisions.[48] The obvious benefit of this procedure is that an investor need not wait for its government to commence a state-to-state procedure before obtaining redress under NAFTA. Under the investor-state procedure, only monetary damages may be obtained from the offending NAFTA country. In addition, if the respondent country in such an action invokes the prudential carve-out, a state-to-state panel can be convened to decide whether the defense is justified.

Prospects for Future Integration and Liberalization

With the basic rules and functioning of NAFTA in mind, it may be appropriate to make a few points on the nature of the economic integration promoted by NAFTA.

NAFTA is very different from the European Union (EU) agreements on financial services. Under the EU's directives, partial harmonization results when each country adopts the minimum standards of regulation legislated by the EU. By each country's adoption of such standards, all countries in the EU can depend upon home country regulation for many aspects of financial regulation, providing in some circumstances a greater range of action for the branches of such institutions in the host country than the competing institutions that have been organized there.

Although NAFTA has no such direct regulatory harmonization, it sets the stage for future integration by enunciating principles throughout Chapter Fourteen that will serve as the basis for future negotiation. For example, in Canada and Mexico, banks, securities firms, and insurance companies can affiliate with each other through holding company or subsidiary structures.[49] In the United States, however, the Glass-Steagall Act, the Bank Holding Company Act, and related laws prevent banks from fully affiliating with securities firms and insurance companies.[50] Under NAFTA, nothing changes in this area.

Article 1403 of NAFTA, however, sets out the principle that each country must *work* to eliminate differences in financial structure in order to permit financial services providers to offer the full range of financial services. For future proceedings under NAFTA, including enlargement negotiations and annual meetings of the Financial Services Committee set up to administer Chapter Fourteen, the United States will continue to face pressure to reform its laws so as more fully to integrate banking and other financial services and thus ease the ability of Canadian and Mexican financial institutions to operate in the United States.

U.S. interstate banking restrictions are treated similarly under NAFTA. Here, too, Article 1403 of NAFTA articulates a principle, namely, that each country *should* permit banks to establish branches throughout their markets. The Mexican and Canadian financial systems permit interstate branches throughout their territories, while the United States traditionally did not permit banks to establish branches across states.[51] NAFTA added an extra incentive to the United States to liberalize. Although Mexico and Canada do not now permit foreign banks to expand into their markets across international borders, the two countries

have agreed under NAFTA to negotiate the liberalization of foreign bank branching legislation, as the United States has also adopted interstate branching legislation.[52] In this way, NAFTA sets the agenda for future liberalization and integration by tying the reaping of benefits in Mexico and Canada to the implementation of reform in the United States. While integration is thus not directly promoted by NAFTA, it is indirectly promoted through the conditions for future liberalization that are enunciated in the text.

Other provisions in NAFTA similary promote liberalization. Cross-border financial services are to be negotiated again by the NAFTA parties in six years.[53] Also, the high capitalization levels for securities firms in Mexico must be addressed by the Mexican Government through a formal report.[54] In each case, future discussions between the NAFTA parties are intended to lead to political pressure to liberalize.

NAFTA's most important move toward liberalization is its program for opening the Mexican financial market, already well under way.[55] Before NAFTA, the Mexican economy was essentially closed to meaningful foreign investment in the financial services sector, as a foreign financial services firm was basically limited to a 30 percent portfolio interest in domestic Mexican banks or securities firms. In insurance and in leasing and factoring, the maximum amount of foreign investment permissible was 49 percent.

NAFTA changed this closed situation by allowing NAFTA-incorporated firms with substantial business operations in the United States or Canada to invest in the Mexican financial system through wholly owned subsidiaries, subject to market share limitations. The market share caps are administered by the Mexican Government through a rationing system, under which the Mexican Government will award a certain amount of authorized capital levels to each foreign bank subsidiary and restrict further licenses or growth when these levels have been met.[56]

The NAFTA transition provisions are important to non-NAFTA governmental authorities because the U.S. Government intends to uphold these provisions as an acceptable way to achieve liberalization. In addition, the presence of U.S. financial firms in the Mexican market will further link the two economies through the increased domestic business that these U.S. institutions will be permitted to conduct. (No Canadian banks initially applied to open a subsidiary, although, as of the date of this publication, several significant Canadian investments in large Mexican financial institutions had been made or announced.)

Balance of Payments Implications

NAFTA sets out a general exception from its obligations when serious balance of payments difficulties threaten or occur in a NAFTA country's economy.[57] The Articles of Agreement of the International Monetary Fund (the IMF Agreement) circumscribe the ability of member countries to "impose restrictions on the making of payments and transfers for current international transactions"[58] but, subject to the language of these Articles, generally allow countries to impose restrictions on capital account transactions.[59]

NAFTA limits, albeit somewhat unevenly, the ability of NAFTA governments to impose restrictions on current and capital account transactions.[60] Restrictions imposed on transfers must be consistent with Article VIII, Section 3 of the IMF Agreement.[61] In the latter case, if the restrictions are imposed on international capital transactions, they must be consistent with Article VI of the IMF Agreement.[62] NAFTA further requires that restrictions imposed when a country is experiencing serious balance of payments difficulties shall avoid unnecessary damage to the economic interests of other NAFTA countries, must not be more burdensome than necessary, must be phased out as the situation improves, and must be applied on a national treatment or most-favored-nation treatment basis, whichever is better.[63] In addition, such restrictions, if on the current account, must be submitted to the IMF for review.[64] Restrictions must be consistent with the IMF Agreement[65] and lead to consultations with the IMF and the implementation of economic policies consistent therewith.[66] In the case of restrictions on transfers other than cross-border trade in financial services, such restrictions may not take the form of tariff surcharges or quotas.[67]

Lessons for Central Banks

There are several important lessons that central banks (particularly those in emerging markets) can draw from Chapter Fourteen of NAFTA. The first and most important lesson is that of policy emphasis: the U.S. Government has placed financial services on the trade policy agenda and may be expected to expend resources and political capital to open markets in the sector. The complexity and sweeping scope of Chapter Fourteen provides the framework for action. Central banks should participate in financial services negotiations, such as the negotiations already under way under the GATS, the negotiations involving Asian countries under the auspices of the Asia-Pacific Economic Cooperation (APEC) forum,[68] and the negotiations in Latin America connected with the

expansion of the Mercado Común del Sur[69] and NAFTA. If central banks ignore these important trends, they will put trade ministries and finance ministries "in the driver's seat" for financial services negotiations, possibly to the detriment of good policy or regulation.

The second lesson is that NAFTA and the GATS are similar. Central banks should follow developments of these two separate bodies of law with interest to ascertain the degree of scrutiny with which regulations governing international financial services will be reviewed. A country that is not a party to NAFTA may nevertheless be affected by NAFTA actions if the GATS jurisprudence uses NAFTA for precedent.

The third lesson is that financial services negotiation can at times be used to overcome domestic constituencies opposed to financial reform. For example, the Mexican banking system has for many years been highly concentrated, with the three largest banks controlling approximately 70 percent of the banking assets. One of the ways to promote competition in the banking sector is to authorize nonbank financial intermediaries to borrow money on the capital markets and make loans with these funds. Such authority did not exist in Mexico during the time of the NAFTA negotiations. The United States urged Mexico to create such a license as a step taken under the agreement. The Mexican Government agreed, thereby achieving a measure of liberalization that might not have occurred absent foreign negotiating interest. Other countries might consider this example when confronting structural problems in their economies while conducting financial services negotiations.

Above all, it is important to recognize that there is no great mystery to financial services in general, or the NAFTA financial services provisions in particular. While the language may appear complex and the trading interests promoted under the agreement may at times appear to take precedence over regulatory interests, in reality countries are unlikely to commence dispute settlement proceedings except to contest the most suspect regulatory measures. Nevertheless, central bankers should study NAFTA as an important new source of law governing financial services regulation.

COMMENT

BORIS KOZOLCHYK

Changed Circumstances

The most important NAFTA-related development concerns the unfortunate events that have befallen Mexico in recent months. In early 1995, the Mexican banking and monetary systems were in the midst of a severe liquidity and confidence crisis. Had it not been for the rescue package arranged by the U.S. Department of the Treasury, the International Monetary Fund, the World Bank, and a number of other public and private sector lenders, a large portion of Mexico's mature dollar debt would have gone unpaid.

Following a drastic devaluation of the peso, large amounts of short-term dollar investment fled Mexico for other markets. Some of Mexico's largest banks were taken over by Mexico's banking authorities. The lack of confidence in public sector and banking debt caused the rates of interest on that debt to exceed 50 percent. While inflation was estimated at approximately 30 percent a year, some merchants and consumers had to pay rates in excess of 100 percent a year for their loans. As a consequence, commercial and consumer default and insolvency threatened.

Meanwhile, the loan loss reserves required by Mexico's National Banking Commission (monies segregated from bank capital and returned earnings, and placed in a special account to cover the eventuality of losses) were increased. This reserve requirement places considerable pressure on the banks' ability to meet both liquidity and capital adequacy requirements: as banks struggle to satisfy their reserve requirements by reducing their net capital, compliance with capital adequacy requirements becomes difficult. In addition, Mexican authorities have begun implementing a program of monetary austerity, which has restricted the supply of lending capital to Mexico's banks, merchants, and consumers.

The severe scarcity of dollars that preceded the austerity measures had already pressured Mexican banking regulators to relax Mexico's exceptions to NAFTA's national treatment principle.[1] These exceptions were intended to usher in competitive foreign financial services gradually over two decades. The sharp devaluation of the peso, the ensuing massive flight of dollars, and the policy of monetary austerity accentuated Mexico's need for foreign lending capital. Accordingly, almost from the time that it was put into effect, the 30 percent limitation of foreign stock ownership of financial institutions imposed by NAFTA[2] was bypassed by

an authorization enabling foreign financial institutions to set up wholly owned subsidiary holding companies.[3] Similarly, Mexico's authorities may be considering the elimination of NAFTA limits on the total market share serviced by foreign banks. If this market share limitation were eliminated, some Mexican banks might easily be acquired or taken over by foreign banks as a result of the present low value of their stock. These acquisitions or takeovers, however, would be strongly opposed by Mexican controlling stockholders, who fear losing not only their control but also most of their investment. The opening of Mexico's financial markets to foreign competition, therefore, is far from being as uneventful, gradual, or evolutionary a process as contemplated by NAFTA.

A Time for Realistic Evaluation

Arguably, this crisis merely precipitated the inevitable. When the Mexican bank nationalization decree was set aside, the newly privatized banks were not acquired in open and public bidding. Also, the high prices paid for the privatized banks did not reflect the true value of their assets. In exchange for being selected as buyers by Mexico's authorities, the buyers paid higher prices than those that could have been obtained in an open market. In addition, they paid either cash or its equivalent. Consequently, the privatized banks started operations with insufficient working capital and with fewer dollars than were needed to repay the continuously mounting dollar debt or to collateralize loans that needed to be supported by dollar-denominated assets. Despite the sharp surge of short-term dollar investments in Mexico during the term of the previous Administration, the dollar debt of the privatized banks did not improve. Consequently, even if the present devaluation had not taken place, Mexican banks would not have been in a position to compete with their NAFTA rivals in financing the acquisition of dollar-denominated raw materials, inventory, equipment, or services.

There is a degree of unreality concerning the financing of cross-border trade obligations in NAFTA's rules on "solicited" and "unsolicited" cross-border trade obligations. While in practice it is difficult to distinguish between unsolicited and solicited transactions, solicited transactions are subject under NAFTA restrictions to a "standstill" commitment: no further liberalization of solicited transactions need occur under NAFTA, but no NAFTA government may become more restrictive than it was when NAFTA entered into force. Considering Mexico's dependency on dollars to finance its industrial, commercial, and tourist endeavors and the scarcity of dollars in its banking system, the NAFTA exceptions and reservations restricting the flow of institutional dollar

loans[4] seem to amount to a protectionist luxury that the nation can ill afford.

The inescapable reality is that for NAFTA to succeed the liberalization of both solicited and unsolicited cross-border transactions must occur. Otherwise, the absence or the high cost of credit with which to acquire raw materials, equipment, inventory, and services will continue to drive small- and medium-sized Mexican businesses into bankruptcy. The survival of much of this vital segment of Mexico's economy is at stake. Similarly, the inability of Canadian and U.S. industrial investors to finance their investments in Mexico by carrying with them their home country lines of credit may continue to prevent significant investments from being made in Mexico. The modernization of Mexico's Secured Transactions Law and its harmonization with Canadian and U.S. law and practice are absolutely necessary for the health, safety, and soundness of the country's banking industry and investment picture.

Chapter 10 | Banking Law Developments in Latin America

JORGE GUARDIA

Introduction

There have been a number of interesting developments in banking law and practice in Latin America, particularly in the past five years. These developments, however, have not taken place in isolation. They form part of a more general economic and political change toward liberalization in the region.

To appreciate the significance of these developments, it is necessary to place them in the proper historical context. The economies of these countries were characterized by the existence of protectionist policies; complex banking, exchange, and trade systems; and distortions that promoted inefficient operations at very high costs. Governments intervened in the market through price controls, subsidies, and other distortions. The growth of the public sector in these economies was accompanied by the transformation of the role of government. This transformation brought about new legal developments, concepts, and jurisprudence, facilitated by liberal court interpretations of the government's right to affect certain constitutional rights, such as free enterprise and private property.

Banking systems in Latin America were seriously affected. Under extensive prohibitions and government intervention in their credit policies, banks were unable to perform well or to develop safely and soundly. The best examples, or perhaps the worst, of constrained banking systems were found in countries where private banks were confiscated and nationalized; credit to the private sector was officially allocated to development and other privileged activities; interest rates were fixed by central banks and often divorced from market reality; and cumbersome licensing systems were in place. Ironically, while credit was scarce and expensive for many productive activities, it was ample and available at low cost to governments and their controlled enterprises.

The results of this approach to development are well-known. High inflation and low economic growth were present in the region for all those years, accompanied by high unemployment, capital flight, exchange rate depreciations, and recurrent balance of payments crises.

As a reaction, a new market-oriented approach to economic development emerged. It was first put into practice in Chile some twenty years ago.[1] The approach has increased in popularity in other Latin American countries in the second half of the 1980s and the early part of the 1990s.

The pioneers of this movement in Chile gradually transformed their system into a market-oriented economy. Practically all areas of production and financial organization, including the public sector, were affected. To reduce inflation, restore confidence in investment, and resume growth, fiscal deficits were reduced. Subsequently, the trade and price systems were liberalized, and the economy of this country, in response, began to grow at very high rates. The financial system was also liberalized, but not without difficulties and setbacks. Commercial banks and financial institutions were freed from restrictions. Interest rates began to reflect market conditions, and credit controls were lifted, enabling banks and financial institutions to undertake their own risks. As a result, credit to the private sector expanded rapidly, banking business flourished, and financial activity increased.

Despite the change, neither banks nor the banking supervisory authorities were fully prepared for sudden and complete liberalization. The availability of credit increased, supplemented by large capital inflows. Increased competition caused banks and financial institutions to undertake riskier operations and, in some cases, to concentrate their investments heavily in a few debtors or interrelated groups without making the necessary provisions for possible default. These practices eventually led to troubles in the banking system.

The banking crisis climaxed under particularly adverse external conditions in Chile in the late 1970s and early 1980s when oil prices escalated. A number of financial institutions failed or came under tremendous financial stress. The central bank was forced to intervene to bail them out. Nevertheless, the authorities acted promptly to rectify the problem: they enacted more effective norms and procedures to control financial institutions, emphasizing prudential supervision. The banking crisis was a hard and costly lesson. It might even have delayed financial liberalization throughout Latin America, as other countries feared that they might experience similar events.

Fortunately, the banking crisis did not end the process of economic and financial liberalization, which resumed more vigorously and spread widely to other countries in the late 1980s. It was led this time by Mexico and Argentina, which embarked upon substantial and comprehensive structural adjustment programs, including price liberalization, the reduction of protectionism, financial openness, and privatization of many government enterprises. These countries were followed by Colombia, Uruguay,

Paraguay, Venezuela, the Dominican Republic, and some of the smaller nations in Central America in the early 1990s, with very commendable results. Inflation and devaluation have been reduced, aided by strong capital inflows and encouraged at least in part by renewed confidence in economic and legal developments. In 1993, the combined rate of growth in Latin America was one of the highest in the world, and the prospects to reduce unemployment and alleviate poverty seem better today than ever.

Developments in Central Banking Law

Redefining the Role of the Central Bank

Banking legislation approved in Latin America in the early part of this decade significantly redefined the role of central banks. The central banks' objectives, which in some instances had been very broadly defined to include the financing of economic development and direct involvement in the attainment of balanced growth and equitable distribution, have been narrowed to the promotion of monetary stability and other secondary but related tasks. The inflationary experience of the past three decades and the unsatisfactory results in real growth made governments realize that they were in a better position to undertake directly the role of development, and that it had been erroneous to overburden central banks with responsibilities other than monetary stability.

The objectives of modern central banks are now more specialized. The Constitutional Organic Act of the Central Bank of Chile restricts the objectives of the Central Bank to "oversee[ing] monetary stability and the proper functioning of the internal and external payments system."[2] In Argentina, the central banking law of 1991 prescribes that "the primary and fundamental mission of the Bank is to preserve the value of the currency."[3] These two provisions are good examples of well-defined objectives for a central bank. The most ambitious, however, is the 1992 Colombian Organic Law of the Bank of the Republic, which not only limits the objectives of the central bank "to maintaining the purchasing capacity of the peso," but also requires it "to adopt specific inflation targets, which shall always be lower than those obtained in the last registered results."[4] This provision gives responsibilities to the Board of the Bank to pursue policies conducive to reducing inflation, regardless of the results that may be obtained in the real sector of the economy. This law is very unusual; although it may not necessarily be the model that others will want to follow, it is certainly noteworthy.

The Senate in Uruguay also has approved a well-balanced provision, which, in part, states:

> The objectives of the Central Bank of Uruguay shall be as follows: (a) to ensure the stability of the national currency, (b) to ensure the normal functioning of the internal and external payment systems, (c) to maintain an adequate level of international reserves, (d) to promote and maintain the soundness, solvency, and proper functioning of the national financial system. . . .[5]

Article 4 of this law, the Organic Charter of the Central Bank of Uruguay, provides that the Central Bank shall be authorized to undertake all the actions and obligations as may be necessary to fulfill its objectives.[6] This language becomes relevant for at least two reasons: first, all the implied powers that the Central Bank might claim in the future should be consistent with the stated objectives; and second, there is a principle in public law under which no public institution can undertake any actions other than those for which it has express authorization in the law. If the objectives are broadly defined—to include, for instance, development activities—the Central Bank would be legally entitled to engage in any activity consistent with development even if it runs counter to the goal of monetary stability. This, however, could not be the case in Uruguay.

Rediscovering Central Bank Independence

Redefining the role of the central bank was a very significant step on the long and difficult path to stability in Latin America. It was not enough, however. Central banks needed to consolidate their independence. A conceptual distinction was drawn between formal independence and effective independence, the first being the central bank's legal capacity to make decisions on matters under its jurisdiction. Formal central bank independence was acquired long ago, when the decision was made to remove the function of printing money from the hands of the institution most likely to spend it. But central banks were chartered banks. Because the government was authorized to subscribe the capital and to become the sole shareholder, it felt it had the right to control the central bank's policies, including the extension of credit. In these circumstances, formal independence did not mean very much. It was necessary to go one step farther.

To secure their independence, many Latin American central banks were granted constitutional status. The most independent of these, by far, is the Central Bank of Chile. The Chilean Constitution provides as follows:

> Article 97. There shall be an autonomous institution of a technical nature, with its own resources, to be known as the Central Bank; a constitutional Organic Law shall define its composition, organization, functions and powers.

Article 98. The Central Bank may only carry out operations with public or private financial institutions. It may under no circumstances extend its guarantee to them, nor may it purchase securities issued by the Central Government, its agencies or enterprises.

In no case may public expenditures or loans be financed through direct or indirect credits from the Central Bank.

In case of war or threat thereof, as determined by the National Security Council, the Central Bank may obtain, grant, or finance credit to the Government and public or private institutions.

The Central Bank may not adopt any provisions that, directly or indirectly, introduce rules or requirements of a different or discriminatory nature against persons, institutions, or entities engaged in operations of a similar nature.[7]

Under the Central Bank of Chile's charter, members of the Board are appointed by the President of the Republic upon confirmation by the Senate, for a period of ten years.[8] The Governor also is appointed by the President from the members of the Board, for a term of five years.[9] Both the Governor and the directors can be removed only for legal cause, and such removal needs to be ratified by the Senate.[10] There is no doubt that these provisions assure members of the Board of Directors and the Central Bank a good degree of independence.

The Central Bank of Argentina is also very independent. It is an "autarchical institution," which has the highest degree of independence under Argentine law. The Board of Directors and the Governor are appointed by the President, upon confirmation by the Senate, for a period of six years.[11] The Central Bank is not subject to orders from the Federal Government,[12] and the directors can be removed only for legal cause, subject to the recommendation of a committee of Congress.[13]

Mexico did not want to trail behind this trend toward central bank independence. Article 28 of its national Constitution was amended to grant the Bank of Mexico constitutional status, to provide for full autonomy in its functions and administration, to clarify that the appointment of directors would be made by the President of the Republic with the approval of the Senate or the Permanent Commission, and to state that their removal would be possible only for legal cause.[14] Directors will no longer serve at the pleasure of the Minister, and the central bank will not be obligated to receive orders or instructions from the Federal Government.[15]

Accountability

The independence of central banks brought along matching responsibilities. In addition to the personal liability for negligence or wrongdoing

that is common to all public officials, some central bankers now face the duty to report to parliament on the activities of the central bank. This obligation is called accountability. The central banks will no longer silently transmit to their governments reports and information that may be embarrassing to disclose publicly. They are now accountable to the politicians in congress. This is democracy at work.

Chile, Argentina, and Colombia are among the countries where reporting to congress is required.[16] In Colombia, announcing the inflation targets set out by the central bank is also a legal requirement, thereby greatly facilitating accountability.

The traditional concept of bank secrecy also has evolved toward transparency and full disclosure. The central banks are now periodically disclosing information on both currency issuance and the levels of their international reserves. This is another welcome development. When full disclosure is mandatory, bank officials tend to be more careful not to let certain key variables move in the wrong direction. Members of the financial community also are able to make better-informed decisions when information is readily available.

Key Functions

Government Financing

The history of Latin America is filled with examples of high inflation associated with central bank financing of the government. Many of the statutes permitted the central banks to extend ample credit to their governments; in some cases, the statutes permitted unlimited access to the resources of the central banks by the public sector. The new trend, however, is to limit significantly the amount of such credit. The most audacious central banks have gone one step farther by mandating zero credit for their governments.

The pace is once again set by Chile and Argentina. Article 27 of the Chilean central bank act prohibits altogether the financing of the Government, including the extension of guarantees, with the sole exception of foreign war or the threat of foreign war.[17] Argentina also prohibits direct financing of the Government.[18] Indirect financing through the acquisition of negotiable instruments issued by the Government is limited: the yearly balance cannot increase by more than 10 percent over the balance held the previous year.[19]

Venezuela has interesting provisions in this respect. Its central banking law prohibits the extension of direct and indirect credit to the Government.[20] It only permits the acquisition of government paper from

the secondary market in open market operations.[21] In this manner, the provisions of direct and indirect credit to the Government is avoided, as government paper purchased by the Central Bank in the secondary market presumably has been acquired by other persons before. In addition, the acquisition of government securities is limited to satisfying the monetary needs of the Central Bank's financial programming.

Interest Rates and Control of Credit

Another interesting development (in some of the banking legislation) is the absence of legal authority for central banks to control the interest rates that financial institutions can charge. Similarly, the laws lack provisions empowering central banks to limit the total amount of credit or to allocate such credit to preferred or privileged activities. This development is one of the clearest examples of the new approach to liberalizing the financial markets that is taking place in law and in practice. The reasoning is that the level of lending and deposit rates must reflect the scarcity of funds, and that the most effective way to control the expansion of credit is through open market operations. It is furthermore believed that freedom to grant credit to all legal activities according to demand and supply will promote a better allocation of resources and growth.

Although central banks seem to be losing to the market those functions that made them so powerful in the past, they are gaining other rights and obligations that will also make them powerful. Such is the case with the Central Bank of Chile, which is now entitled under Article 35 of its law to set the terms and conditions for the operation of participants in the capital market and the financial system.[22] The Central Bank of Argentina, which could set interest rates only for its own securities, can now establish all the technical solvency requirements and liquidity ratios that banks and financial institutions must observe.[23] Similarly, the Central Bank of Uruguay will not be able to control interest rates, but it will have the power to set the maximum exposure that banks and financial institutions can undertake in foreign currencies.[24]

Exchange Rate Systems

The debate over the best exchange rate system for developing countries has been extensive in Latin America. Comparative analysis of old and new legislation leads to no definitive conclusions. Practically all exchange systems can be found in the region, and each has advantages and disadvantages.

References to par values still remain in the statutes of many countries, while flexible exchange regimes are now in place in other countries. At

one extreme, there are countries such as Costa Rica, whose Constitution still dictates that the par value of the national currency, and any change thereof, must be established by a formal law of Congress.[25] In Venezuela, the central banking law enables the Central Bank to let the bolivar float freely in the market, but the consent of the Minister must be obtained beforehand.[26]

Argentina has perhaps the most intriguing provisions. Article 29 of its central banking law authorizes the Central Bank to establish rules to govern exchange transactions.[27] In addition, Congress sanctioned a new version of the old gold standard, under which the austral was made convertible into U.S. dollars at a rate of 10,000 australs per U.S. dollar.[28] (Subsequently, the austral was changed into Argentine pesos at a rate of 10,000 australs per Argentine peso, so that one Argentine peso is equivalent to one U.S. dollar.) Quotations in the exchange market can still vary, and the Central Bank must stand ready to intervene in the market when appropriate to do so.

Chile, however, opted for establishing its exchange system directly in the law and thus prevented the Central Bank from modifying it. The exchange system chosen is rather free. All persons have the right to enter freely into exchange transactions.[29] Although the Central Bank has the authority to introduce certain exchange restrictions affecting the capital account, commercial banks are free to set the corresponding exchange rate.[30]

Developments in Bank Supervision

There have also been developments in bank supervision, both in the law and regulations, prompted by the liberalization of the financial system, growing technological advances, and the integration of world financial markets. The underlying philosophy is that banks and financial institutions should be free to allocate credit according to market forces and should be entitled to set the terms and conditions for their operations in an environment of ample competition. However, very strict rules should be set for bank behavior, particularly concerning risky operations, in order to protect depositors and the financial system as a whole. For these purposes, a number of financial requirements, restrictions, and obligations have been incorporated in some of the most recent banking legislation, including provisions to strengthen the powers of the supervisory authorities.

Articles 1 and 49 of the Credit Institutions Law enacted in Mexico in July 1990 summarize this philosophy and the comprehensive approach taken to banking legislation:

> The purpose of this law is to regulate banking and credit services, the organization and operation of credit institutions, the activities and operations they may undertake, their sound and balanced development, the protection of the public's interests, and the terms on which the State will exercise its financial oversight of the Mexican banking system.
>
> Credit institutions shall invest the resources they obtain from the public and carry out the operations that give rise to their contingent liabilities on terms that will allow them to maintain adequate security and liquidity conditions. The Secretariat of Finance and Public Credit, after consulting the Bank of Mexico and the National Banking Commission, shall determine the ratings of assets and of operations giving rise to contingent liabilities, and of such other operations as the Secretariat itself may determine, on the basis of their security, and shall likewise determine the maximum percentages of current liabilities and contingent liabilities that may be represented by the various groups of assets and operations arising from said ratings. . . . [31]

Some other important supervision provisions can be summarized as follows. Article 50 prescribes that credit institutions must maintain at all times a minimum capital equal to no less than 6 percent of their total assets, classified and valued in accordance with the corresponding risks involved. Past gains or losses must be added to, or deleted from, the capital account. Article 51 permits the Minister to establish, by regulations, the limits on credit that a bank can lend to related persons. Articles 99–102 contain a detailed list of requirements for proper accounting, financial reports, and valuation rules. The law includes rigid provisions on permitted and prohibited operations and transactions, intervention with respect to failing institutions, and sanctions.

One of the novel provisions found in this law is contained in Article 52, which enables banks to enter into contracts with the public electronically. The contracts must state

- the operation and services covered,
- the means of identification and the corresponding responsibilities, and
- the means to create, modify, transmit, or terminate the corresponding rights and obligations.

Article 52 further stipulates that the means created by contract in substitution of the personal signatures shall produce the same legal effects that the law grants to the corresponding instruments.

Conclusion

The most interesting development in banking law in Latin America is the philosophical change that is taking place. The new approach toward

central banking legislation is definitely more modern, market-oriented, and favorable to the development of a free, competitive, and efficient financial system geared toward integration with its larger partners in the world economy. Under the new approach, the central bank is called upon to concentrate on monetary stability. It will no longer seek to control the fate of the productive sector by directly allocating financial resources, granting subsidies to stimulate privileged activities, or fixing interest and exchange rates to postpone the adjustment of macroeconomic imbalances.

In addition, although free enterprise is the new approach, bank supervision and prudential control to protect depositors and the financial system are stricter and more severe than ever. This is a welcome change.

Other interesting developments in banking law include the independence that the central banks are gaining, reinforced by the required agreement by legislatures with respect to the appointment of directors; the new role of the superintendency, more independent and powerful than before; the introduction of more precise and comprehensive definitions of banks, banking business, and financial institutions, similar to those prevailing in common law countries; the adjustments of capital requirements for banks and financial institutions and the maintenance of their net wealth values in real terms under a sophisticated classification system for assets and liabilities, together with the corresponding provisionings; the classification and valuation of assets and stand-by credits under international standard rules; and the more active role to be played by external auditors, whose opinions will have to address issues of compliance with the law by financial institutions.

It is fair to say that central banks and the associated banking legislation in Latin America are moving in the right direction. It is to be hoped that the provisions incorporated in the laws of the pioneering countries will be harmonized with those of their neighbors and extended to all territories, from the Rio Grande to Tierra del Fuego.

COMMENT

ERNESTO V. FELDMAN

This comment focuses on issues that deserve consideration in reviewing banking law developments in Latin America. First, the comment will consider the role of central banks and the corresponding need for legislation to regulate and manage the payments systems of domestic financial markets. It will then address the role played by state-owned banks in the performance of these systems.

Role of Central Banks

Recent legal developments in banking law and practice in Latin America must be considered in historical context. Traditionally, central banks' powers in Latin America have been misused and abused, not only by their financing of public sector deficits but also by their embarking on various quasi-fiscal activities that not only put in jeopardy the basic objectives of price stability but also fueled inflation and led to some well-known hyperinflationary episodes in several countries.[1]

The situation in Latin America has changed dramatically, particularly during 1990–93, notwithstanding the recessions experienced by industrial countries. After the uneven and painful adjustment phase following the emergence of the debt crisis, the region has had an impressive turnaround. Since 1990, substantial progress has been made in reducing macroeconomic imbalances, lowering inflation, and—something that was completely absent in the 1980s—improving growth performance. Excluding Brazil, the region's output rose by about 3½ percent a year during 1990–93, compared with an average rate of about 1 percent during 1983–89. It is premature to talk about consolidation of the economic situation as many challenges remain unsolved; however, the recent legal developments in banking constitute a necessary, albeit not sufficient, condition to support the movement toward a more market-oriented stance in the region.

An overwhelming trend exists in modern central banking legislation, particularly in Latin America, to adopt a narrow definition of central banking objectives. While a narrow definition that points to the achievement of low inflation or price stability is effective, other central banking objectives, such as those related to the appropriate functioning of the payments system and to the soundness of the financial system, must not

be neglected. These objectives are subsidiary to the central objective of price stability, but they should not be disregarded. Meeting these objectives would reinforce and complement the achievement of price stability. There has been a tendency in policy debates and in the literature on banking to perceive a conflict of interest between the objectives of monetary policy and banking regulation. This line of thinking would imply, for example, that implementing a tight monetary policy might jeopardize the solvency of the financial sector and that the objectives of price stability and soundness of the financial system may be in conflict. However, such a conflict is not a necessary outcome.[2] The adoption of appropriate macroeconomic policies would facilitate the development of a harmonious relationship between the monetary and regulatory objectives. A challenge for banking legislation is thus to help make consistent and harmonize these two objectives. This is a controversial issue, strongly related to the question of central bank independence, which banking legislation should continue to address. This legislation should contribute a detailed and clear framework that coordinates policies and resolves conflicts.

Accountability is also a crucial concept for financial modernization. It should apply to the central bank, and, to the extent possible—and without abrogating the traditional concept of bank secrecy—it should also be extended to the entire financial system. If, because of confidentiality rules, full disclosure is not feasible, legislation should be designed in a way that maximizes the dissemination of information among those demanding bank services.

The role of the central banks in regulating and managing payments systems is, in turn, related to the function of central banks as "lenders of last resort." Precisely because of the complementary nature of central banking functions, central banks should help maintain appropriate levels of liquidity. This is tantamount to granting central banks the role of lender of last resort and manager of the payments system. This point is highly controversial, and it may be argued that, although central banks should regulate the payments systems and intervene to solve payments problems, they should not manage those systems. However, central banks should manage payments systems, particularly in the still fragile financial sectors of Latin America. Functioning as a lender of last resort and providing a rational deposit insurance scheme are basic central bank functions, linking monetary policy and banking supervision. In some countries, there is a tendency to associate the modernization of the payments system with the incorporation of new technologies, while neglecting or lagging behind in the introduction of legislative and regulatory aspects. Legislation on the functioning of the payments system, with all its present technological and institutional intricacies, constitutes a crucial

instrument needed to avoid the emergence of systemic crisis in the financial systems.

Role of State-Owned Banks

Finally, state-owned banks present one of the most significant and neglected issues, in both the theory and the practice of banking. State-owned banks have played a dominant role in the financial sectors of Latin America and elsewhere. When Latin American governments followed an interventionist policy, the state-owned banks' function was shaped by the monetary authorities' aim to channel subsidized resources to sectors and regions that would most likely not be provided for under a market-oriented policy, and to manipulate sizable amounts of financial resources pertaining to public enterprises. In performing these activities, state-owned banks would most often circumvent monetary and regulatory rules; in other words, they became the frustrators of monetary policy and other regulations.

Unless state-owned banks are privatized or seriously streamlined and restructured, and unless legislation contemplates explicitly the modus operandi of these institutions, they may, in this new era of central bank independence, frustrate market-oriented policies, adopting themselves some of the interventionist roles previously performed by central banks.[3] A crucial and difficult legislative task ahead is to avoid the exploitation of loopholes, which the legislation on central banks and on financial intermediaries in general has thus far not been able to avoid. For example, in 1992, one Latin American country enacted market-oriented central banking legislation. However, the legislation on state-owned banks was not essentially changed, and these banks' modus operandi continued to be highly interventionist. Hence, the distortion of resource allocation generated in the financial system by these institutions has not stopped.

An important challenge facing policymakers and lawmakers is to identify and remove the mechanisms by which state-owned banks can remain an obstacle to the transmission of monetary policy. While adequate banking legislation would certainly contribute to overcoming such a situation, the political determination to continue implementing stabilization and structural adjustment programs remains crucial.

Chapter 11 | U.S. Banking Regulation Roundtable

11A. Report from the Board of Governors of the Federal Reserve System: Establishing Foreign Bank Offices in the United States

J. VIRGIL MATTINGLY, JR.

Introduction

There is no doubt that financial markets globally are becoming more integrated. One important aspect of that integration from the point of view of the Board of Governors of the Federal Reserve System (the Federal Reserve Board, or the Board) is the entry and expansion of non-U.S. banks in the U.S. market. This chapter briefly addresses the role of the Federal Reserve in the implementation of the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA).[1] FBSEA is the most recent major piece of U.S. legislation concerning the offices of foreign banks in the United States.

Growth of U.S. Activities of Foreign Banks

Over the past two decades, the presence of foreign banks in the United States and their importance to the U.S. financial system and economy have grown substantially. From year-end 1973, the first year for which the Federal Reserve collected data, through year-end 1992, the reported assets of branches and agencies of foreign banks located in the United States grew from $25 billion to more than $700 billion. By comparison, over the same period, assets at domestic offices of U.S. banks increased about threefold, to more than $3 trillion. U.S. branches and agencies of foreign banks currently account for about 18 percent of assets of all banking offices in the United States, a considerable increase from the 3 percent at year-end 1973. Moreover, recently collected data show that the assets of branches and agencies of foreign banks operating in the United States, in combination with their branches in offshore banking centers, had about 30 percent as much in total assets as all U.S. banks. With commercial and industrial loans to U.S. borrowers of more than $220 billion, these offices of foreign banks have extended about one-half as much in

business loans to U.S. residents as all U.S. chartered banks. This growth, coupled with cases of fraud and other criminal activity by certain banks in the 1980s, convinced the Federal Reserve that U.S. regulators, both state and federal, needed to pay greater coordinated attention to the U.S. offices of foreign banks. In particular, the Federal Reserve came to believe that there should be prior federal review of foreign bank entry and expansion in the U.S. market and that there should also be a federal role in terminating an office of a non-U.S. bank for unsafe and unsound banking practices.

Foreign Bank Supervision Enhancement Act (FBSEA)

FBSEA, which was based on a legislative proposal submitted by the Federal Reserve Board to the committees of the U.S. Congress responsible for banking matters, became law on December 19, 1991.[2] The statute was intended to close gaps in the supervision and regulation of foreign banks in the United States and to ensure that foreign and domestic banks were regulated consistently.[3] FBSEA established for the first time uniform standards at the U.S. federal government level for the entry and expansion of non-U.S. banks in the U.S. market and substantially increased the role of the Federal Reserve in the ongoing regulation and supervision of their activities.

While FBSEA amended the International Banking Act of 1978, the core statute that regulates the U.S. branches, agencies, and representative offices of foreign banks, FBSEA was not intended to change the basic policy of according national treatment to foreign banks that is embodied in the International Banking Act.[4] The principal requirements contained in FBSEA—enhanced supervision and increased examinations by a federal regulator, and a demonstration that the non-U.S. bank is subject to comprehensive supervision on a consolidated basis—are equivalent to the requirements imposed on U.S. banks.[5]

Implementing FBSEA

Through FBSEA, the U.S. Congress substantially increased the responsibilities of the Federal Reserve by expanding the scope of its regulatory and supervisory duties with respect to non-U.S. banks. Since its enactment, the Federal Reserve has devoted substantial effort and resources to ensure that FBSEA's mandate of enhanced supervision of non-U.S. banks is fulfilled as expeditiously, yet as carefully and thoroughly, as possible. Similar to any statute constructing a new regulatory and supervisory framework, FBSEA has presented many challenging

issues of implementation. For example, in order to assure compliance with a provision of FBSEA requiring annual examinations of foreign branches and agencies,[6] the Federal Reserve was required to hire and train large numbers of new examiners in a very short space of time. Moreover, both the Federal Reserve Board and the Federal Reserve Banks have been required to increase their legal staffs significantly. While implementation has come a long way since the date of enactment of FBSEA, this process is a continuing one. The Federal Reserve expects that, over time and with the benefit of experience, it will be able to perform its duties under FBSEA more efficiently and more effectively.

Since the enactment of FBSEA, the Federal Reserve Board has taken the following actions, among others, to implement its provisions.

Rule Making

In January 1993, the Board issued a final rule implementing the provisions of FBSEA that require prior approval of the Board for the establishment of branches, agencies, commercial lending companies, and representative offices by non-U.S. banks.[7] The final rule, which superseded interim rules that the Board had adopted in April 1992,[8] contains provisions concerning examinations and lending limits.[9] The section of the Board's final rule implementing the comprehensive consolidated supervision standard of FBSEA sets forth a number of illustrative factors that the Federal Reserve will consider in evaluating whether the standard is met in a particular case.[10] These factors were included in the rule in recognition of the fact that different supervisory systems deal with particular supervision issues in different ways. For example, not all systems rely on on-site examinations to the same extent as that of the United States, and financial accounting practices may differ from one jurisdiction to another. As part of the final rule, the Board requested additional public comment on those portions of the final rule that deal with representative offices of foreign banks.[11] Comments were sought on the definition of a representative office and on the standards that should govern the activities of a representative office. Following review of the public comments, the Board took further action with respect to representative offices in January 1996.[12]

Capital Equivalency Study

In June 1992, the Board and the Secretary of the Treasury issued under FBSEA a Capital Equivalency Study,[13] which examined the capital standards under which non-U.S. banks operate and also established guidelines to be used in evaluating the capital of non-U.S. banks applying

to conduct business in the United States. In broad terms, the study concluded that the minimum capital standards established by the Basle Capital Accord[14] provide a common basis for evaluating the general equivalency of capital among banks from various countries.

Subsidiary Study

In December 1992, the Board and the Secretary of the Treasury issued a Subsidiary Requirement Study,[15] which examined the issue of whether, under FBSEA, non-U.S. banks should be required to operate in the United States only through subsidiary banks and not through branches and agencies. The study concluded that non-U.S. banks should not be limited to operating in the United States only through subsidiaries.

Powers of State-Licensed Branches and Agencies

In January 1993, the Board issued for public comment proposed regulations implementing a provision of FBSEA to limit the powers of state-licensed branches and agencies of foreign banks to those powers held by federally licensed branches.[16] The Federal Deposit Insurance Corporation (FDIC), which, together with the Board and state banking authorities, supervises state branches and agencies, issued its companion proposed regulation in late March 1993.[17] Following review of the public comments and in consultation with the FDIC, the Board issued a final rule with respect to powers of state branches of non-U.S. banks in November 1994.[18]

Application Procedures

In March 1993, the Board announced new procedures designed to streamline the review of FBSEA applications.[19] Most notably, the new procedures establish simultaneous review of applications by staff of the Federal Reserve Bank and the Board and impose deadlines for the preacceptance phase of review.[20]

Comprehensive Supervision and Regulation on a Consolidated Basis

FBSEA permits the Board to terminate the activities of a non-U.S. bank's branch, agency, or commercial lending company if the non-U.S. bank is not subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor.[21] In making its decision to terminate, the Board may consider the bank's relative size and length of operation in its home country, and the effect of termination on the

commerce and trade of the community in which the bank's office is located.[22] However, the size of a non-U.S. bank may not be the sole determinative factor in the decision to terminate its offices in the United States.[23] Thus, the offices of a non-U.S. bank from a smaller country, particularly a bank that is from a developing country and that is relatively small in terms of assets, will not be at risk solely because of its small size. FBSEA requires the Board, in consultation with the Secretary of the Treasury, to develop and publish criteria to be used in evaluating the operation of any non-U.S. bank in the United States that the Board has determined is not subject to comprehensive supervision or regulation on a consolidated basis.[24] The Board developed proposed criteria in consultation with the Department of the Treasury and the Office of the Comptroller of the Currency (OCC).[25] The Board is expected to issue a final rule in early 1996. Until such time as the guidelines are issued, it is the policy of the Federal Reserve to take appropriate action against a non-U.S. bank when the most recent examination of the bank's U.S. office has identified material deficiencies that may be related to home country supervision. Such action could include placing limitations on the foreign bank's U.S. operations, consulting with the home country supervisor, and, in extreme cases, initiating action to terminate the foreign bank's U.S. operations. While publication of the criteria required by FBSEA will make the process of evaluating existing foreign bank operations in the United States more transparent, the Board does not anticipate that the criteria will represent a substantial change in this policy.

FBSEA Applications

As of May 1994, the Federal Reserve has accepted 37 applications by foreign banks to establish branches, agencies, and representative offices. The Board has approved 14 of these applications from banks chartered in Chile, France, Hong Kong, South Korea, Spain, Switzerland, Taiwan Province of China, and the United Kingdom. Eight applications have been withdrawn by the applicants.

Before the Board staff takes an FBSEA application to the Board for approval, it must be confident that the record will support the findings that the Board is required to make under the statute. Two crucial findings are that the applicant bank and any parent foreign bank are each subject to comprehensive consolidated supervision by a home country regulator and that the applicant bank and any parent have provided adequate assurances that the Board will have access to the information that it deems necessary to determine safety, soundness, and compliance with U.S. law.[26] In order for the Board to make these findings, Federal Reserve staff must obtain information on the home country supervision of the applicant and

the confidentiality restrictions in the major jurisdictions in which the applicant and its affiliates operate. This information is obtained directly from the applicant, from correspondence and consultation with the home country regulator, and from the Board's own internal information sources.

The Board makes its comprehensive consolidated supervision determinations on a bank-by-bank basis rather than a country-by-country basis. Nonetheless, once a determination of consolidated comprehensive supervision has been made for a bank from one country, a subsequent applicant from the same country will be required only to indicate the extent to which it is supervised in the same manner as the approved applicant and to discuss any material differences in supervision. For example, such differences are ones that could have arisen because of the passage of time or because the applicant is a different category of banking institution from the previously approved non-U.S. bank. In 11 of the foreign bank office applications approved by the Board, the Board has made findings regarding the existence of comprehensive consolidated supervision. These approved applications are from banks in Chile, Hong Kong, South Korea, Spain, Switzerland, Taiwan Province of China, and the United Kingdom.

In regard to access to information, the Board requests from applicants information on the impediments to disclosure of information in any jurisdiction in which the bank applicant or its affiliates conduct material operations. In addition, the Board requests from the applicant and its ultimate parent a commitment that each of them will provide information to the Board, to the extent permitted by applicable law, and, if impediments to disclosure of information arise, that each will cooperate with the Board to obtain any relevant waivers or consents that would permit such disclosure. Finally, the Board has conditioned each of its approvals so that the failure by the applicant or its parent to provide necessary information would justify termination by the Board of any of the applicant's U.S. activities or, in the case of a federally licensed branch or agency, a recommendation of termination to the OCC.

Other key standards that the Board examines in FBSEA applications include the compliance of the applicant with U.S. law and the integrity and competence of management.[27] A necessary source of information on these standards is the name checks requested by the Board from other government agencies on the applicant foreign bank, certain shareholders, and key personnel. These checks generally are conducted with the Central Intelligence Agency, the Department of State, the Federal Bureau of Investigation, the Drug Enforcement Agency, the Immigration and Naturalization Service, the Customs Service, the Securities and Exchange Commission, the Federal Reserve Board's Enforcement Unit, and, as appropriate, the Department of the Treasury and Interpol.

Obtaining and analyzing the requisite information for FBSEA applications has proved more time-consuming than the Board and staff originally expected. In particular, the name checks have caused and continue to cause delay in the processing of FBSEA applications. However, in the wake of the Bank of Credit and Commerce International and Banco Nazionale del Lavoro scandals,[28] the Board believes that it is prudent to conduct these checks, and it anticipates that they will continue to delay processing of the applications.

The Board has taken a number of steps designed to expedite the completion of name checks and believes that the time frames for their completion may improve in the future. Other agencies have been cooperative in these efforts.

Supervision and Examinations

Beginning in 1992, the Federal Reserve instituted a monitoring program to ensure that all state- and federally licensed branches and agencies were examined annually, as required by FBSEA.[29] In the case of state-licensed foreign bank operations, each Federal Reserve bank annually coordinates with the state licensing authority to ensure that the operation is examined as required. Examinations may be conducted solely by a state banking authority or the Federal Reserve, or they may be conducted jointly by both agencies. The Federal Reserve is working with other regulators, including the Conference of State Bank Supervisors, to develop a comprehensive supervision manual for U.S. branches and agencies of foreign banks. This manual will provide common policy and procedural guidance in the examination and overall supervision of these offices. In conjunction with this project, the examination report of U.S. branches and agencies is being revised to focus more clearly on areas of supervisory concern. When complete, the revised report will be presented for the approval of other U.S. bank regulators.

Additionally, the Federal Reserve is developing a supervisory program for state-licensed representative offices of foreign banks. This program includes a onetime registration of all these offices, the development of examination procedures, which are currently being field-tested, and the implementation of any off-site monitoring procedures.

Conclusion

Non-U.S. banks currently play an important part in the U.S. financial system. Through FBSEA, the U.S. Congress has granted the Federal

Reserve an important role in the oversight of the entry and activities of non-U.S. banks. The Federal Reserve takes this responsibility very seriously because, as financial markets become more integrated, foreign banks will have an increasing influence on the economy.

11B. Report from the Federal Deposit Insurance Corporation: National Deposit Insurance Has Worked to Promote Banking Stability

THOMAS A. ROSE,[1] CHRISTINE M. BRADLEY, and LINDA L. STAMP

Overview

During the 1980s, bank failures soared to levels not seen since the Great Depression of the 1930s. During those years, the Federal Deposit Insurance Corporation (FDIC) was able to cushion the collapse of about one-tenth of the U.S. banking system, contain the damage, and proceed to clean up the wreckage while maintaining public confidence in the U.S. financial system. For over 60 years, the FDIC has been successful in maintaining public confidence in the banking system.

Prior to the establishment of the FDIC, large-scale cash demands of fearful depositors were often the fatal blow to banks that otherwise might have survived. Widespread bank runs have become a thing of the past and no longer constitute a threat to the industry. Even during the 1980s, with bank failures at record levels, bank runs were rarely experienced and readily contained. Money supply on both a local and national level has ceased to be subject to the radical contractions caused by bank failures in the past.

To meet these challenges, the FDIC relied on the mechanisms put in place in response to the Great Depression, underwent fundamental changes, and shouldered once-unimaginable responsibilities.[2]

Structure of the U.S. Banking Regulatory System

The U.S. banking regulatory system has been formed over the past 130 years. It is a complex system, owing in part to the overlapping responsibilities of the various regulatory agencies. Today, at the federal level, the Office of the Comptroller of the Currency (OCC) directly charters and regulates national banks.[3] The Office of Thrift Supervision directly regulates federally chartered savings and loan associations and has some oversight over state-chartered institutions.[4] The Board of Governors of the Federal Reserve System, which is the central bank of the United States, directly regulates bank holding companies and those state-chartered banks that are members of the Federal Reserve System.[5] The FDIC directly regulates state-chartered banks that are not members of the

Federal Reserve System and insures the deposits of all of the insured depository institutions, including savings and loan associations.[6] This complex system has evolved out of a long-standing public distrust of a strong central bank, dating back to the abolition of the Bank of the United States in 1832. Although several bank consolidation schemes have been proposed in the U.S. Congress,[7] these proposals are often criticized for placing too much power in the hands of a few regulators and thus risking greater politicization of the regulatory framework, and possibly eliminating healthy competition among regulators to develop open-minded approaches to new ideas and products.

History of the FDIC and Bank Failures

Early Years

About 9,000 banks suspended operations between the stock market crash in the fall of 1929 and the end of 1933; 4,000 banks closed during the first few months of 1933, and the panic that accompanied these suspensions led President Roosevelt to declare a bank holiday on March 6, 1933. At that point, the financial system was on the verge of collapse, and both the manufacturing and agricultural sectors were operating at a fraction of capacity.[8] Although experiments with deposit insurance at the state level date back to 1829, it took this crisis environment for the public to demand national deposit insurance. The FDIC, originally created as a part of the Federal Reserve Act, was signed into law by President Roosevelt on June 16, 1933.[9]

The history of the FDIC cannot be considered apart from concurrent changes in economic and banking conditions. The early years of the FDIC's existence were marked by caution: banks did not take much risk, and regulators kept banks and banking practices within narrow bounds of competition. Congress and the public had been chastened by the experiences of the Depression and viewed unfettered competition as having led to excesses and abuses.

From 1934 through 1941, the FDIC handled 370 bank failures, most of which involved small banks. Without the presence of federal deposit insurance, the number and size of bank failures would undoubtedly have been greater. Indirectly, the presence of deposit insurance may have encouraged the retention of restrictive state branching laws and maintained a number of independent unit banks that otherwise would have been compelled to merge.

World War II

During World War II, government financial policies and private sector restrictions produced an expanding banking system. Total bank assets at the end of 1945 were nearly double the $91 billion total at the end of 1941. Large-scale war financing, including lending to bond buyers, contributed to this growth. Loan losses during this period were practically nonexistent, and only 28 banks failed from 1942 to 1945.

Post-World War II

Conservative banking practices and favorable economic conditions resulted in few bank failures during the late 1940s and 1950s. Some viewed the low incidence of bank failures as a sign that the bank regulators were overly strict and had gone too far in the direction of ensuring bank safety. Until about 1960, banks continued to operate in an insulated, highly regulated environment. Gradually banks began to change their operations to strive for more growth in assets, deposits, and income. Large banks led the aggressive trend to greater risk taking by pressing the boundaries of allowable activities. In addition, some states began to liberalize branch banking laws, and the holding company model was developed as a vehicle to allow banks in other states to achieve similar accumulations of capital and establish multioffice facilities.

1970s

Until the mid-1970s, U.S. banks were not noticeably harmed by the movement toward increased risk taking. Generally favorable economic conditions allowed many borrowers who might have been marginal credit risks to repay their obligations, and bank failures remained at low levels. The recession of 1973–75 led to real estate loan problems, which ultimately caused the bank failure rate to increase to a peak of 16 percent in 1976. In 1978, interest earned on securities began to outstrip yields on time accounts payable by depository institutions, and deposit growth slowed as these alternative investments became more attractive.

1980s

As the 1980s began, several factors undermined the banking industry's traditional approaches to profitability. High and volatile interest rates caused an outflow of funds from banks and thrifts because they were subject to interest rate caps on deposits. Banks, however, were not burdened with the same high proportion of long-term fixed-rate assets as the thrifts. As banks' assets were generally of much shorter duration, yields

were more closely tied to the prime rate, and banks could more readily adjust the price of loans and other assets upward as the cost of funds increased.

Beginning in the late 1970s and continuing into the 1980s, both banks and thrifts experienced increased competition from nonbanks. By issuing commercial paper, nonfinancial corporations eroded the banks' traditional, safe, and profitable intermediary role in commercial lending on the asset side of the balance sheet. On the liability side of the balance sheet, money market mutual funds attracted substantial amounts of liquid funds that would formerly have been placed in low-cost deposits in banks and thrifts.

As a result of the geographic and product limitations on U.S. banks and thrifts, the industry was unconcentrated and segmented, compared with the depository industry in other countries. Thousands of institutions existed in insulated markets, effectively limiting competition. Lack of competition and existing regulatory restrictions hampered innovation in products and services, while nonbank institutions unconstrained by this regulatory environment intruded on the banks' traditional markets. Technology and the increased access to information that it provided accelerated the process of eliminating the dependence on local banks to deliver financial services. Overcapacity in U.S. bank and thrift sectors also contributed to the consolidation that the industry experienced in the 1980s, although capacity in banking is difficult to measure as the ultimate product is intangible.

In addition, banks and thrifts had other difficulties, involving loans to less-developed countries and to the energy, agriculture, and real estate sectors of the U.S. economy. In the real estate market, the distress began in the Midwest with the weakness in the agricultural economy, moved into Texas and the West with falling energy prices, and then spread to the Northeast, the Southeast, and finally the West Coast, as the rolling recessionary factors caught up with the industries concentrated in those geographic areas. With respect to the real estate sector, Congress may have contributed to the upswing in speculative prices through its tax cuts in 1981, which contained accelerated depreciation provisions and investment tax credits that made real estate investments artificially attractive.[10] When Congress subsequently enacted the Tax Reform Act of 1986, which reduced depreciation benefits, restricted passive loss deductions, and eliminated favorable tax treatment of capital gains, it may have also accelerated the downturn in the real estate market.[11] Because the benefits of real estate ownership were so substantially and abruptly reduced, real estate values plummeted, resulting in tremendous banking losses.

In an attempt to curtail the deficiencies present in the financial system, Congress enacted in 1980 the most sweeping banking deregulation legislation since 1933.[12] This legislation required interest rate ceilings to be lifted by 1986, liberalized the lending powers of federally licensed thrifts, and raised the federal deposit insurance limit for both banks and thrifts to $100,000. In 1982, further bank deregulation legislation gave regulators more flexibility in dealing with failing institutions.[13] A severe recession in 1981–82, additional risk taking by banks to maintain interest margins in the face of rising liability costs, excessive loan concentrations in fragile industries, and an oil surplus resulting in declining prices in that industry all caused loan charge-offs to increase by more than 50 percent in 1982 alone. In 1982, the number of bank failures hit 42, which was a new post-World War II high, and, in 1983, 27 banks failed.

During the 1980s, the rate of thrift failures increased dramatically, and the Federal Savings and Loan Insurance Corporation, which insured the deposits of savings and loan associations, became insolvent. For the first time, taxpayer money was required to pay for deposit insurance obligations when resolving failed savings and loan associations.[14]

Many critics anticipated that a similar insolvency could hit the FDIC as it honored its deposit insurance obligations with U.S. banks, which also began to fail at record levels. Between 1984 and 1993, 1,381 banks failed, with total assets valued at $217.5 billion.[15] Although the FDIC has succeeded to date in surviving this banking crisis without infusions of U.S. taxpayer money, observers urged Congress to enact deposit insurance reforms.

1990s

Since 1989, Congress has enacted several additional pieces of major banking legislation. First, it enacted in 1989 legislation that, among other things, defined and expanded the powers of the FDIC as the conservator or receiver of failed insured depository institutions.[16] This legislation has been important to the FDIC and the deposit insurance funds primarily for the way that it dealt with the administration of receiverships and conservatorships of these failed institutions. However, except to the extent that it assessed liability for any loss incurred by the FDIC on institutions that are commonly controlled,[17] the legislation did not generally address the overall risk-taking behavior of financial institutions.

In contrast, when Congress passed additional banking legislation in 1991,[18] the risk-taking behavior of financial institutions became its main focus. This legislation contained provisions that, among other things, adopted a system of risk-based capital, provided for prompt corrective

action, mandated early intervention when critical capital levels reached the 2 percent level, modified the FDIC's cost test in closed-bank transactions (giving the FDIC less discretion to pay uninsured depositors and other creditors), modified the systemic risk test for the "too-big-to-fail" doctrine in major bank failures, limited the FDIC's discretion to pay foreign depositors, and gave the FDIC authority to impose assessments on banks based on risk.[19] Again, in 1993, when Congress adopted a national depositor preference[20] as a budgetary relief measure, it made a further public policy decision concerning the risk-taking behavior of depository institutions and determined to place the risk of market discipline on the nondeposit creditors of such institutions.

Therefore, in enacting risk-based enforced capital standards, together with national depositor preference, Congress seems to have accepted the argument that public policy should discard depositor discipline and rely on other factors to restrain bank risk. Market discipline and supervision work in tandem to control risk. Therefore, Congress has chosen to increase the regulators' ability to close insolvent institutions in a more timely fashion, relying on risk-based equity as the appropriate measure for determining solvency and requiring that all federally insured banks protect the FDIC against losses in any banks owned by a common parent.

Conclusion

The deposit insurance system and the FDIC did not face a severe test within the first 50 years of their creation. During the 1980s, however, when the rate of bank failures increased dramatically without a major disruption in the financial markets, the effectiveness of the deposit insurance system was tested, and the FDIC's ability to contain the crisis was proven.

The deposit insurance fund established for commercial banks ended 1992 with a negative balance of $7 billion, but the fund had a positive balance of $13.1 billion by the end of 1993.[21] In the first five months of 1994, there were only two bank failures, involving total assets of $186.3 million. Although no one can predict what specific role the FDIC will play in the years to come, the FDIC will continue to adapt to the changing economic conditions and shifts in the banking environment in order to protect insured deposits with minimal disruption to the U.S. economy and financial markets.

11C. Report from the Office of the Comptroller of the Currency: The Future of Bank Supervision

RAIJA BETTAUER

This paper addresses how bank supervision must change and how the Office of the Comptroller of the Currency (OCC) is engaged in changing it. Supervision is not a new interest to the OCC, which has been supervising banks for 130 years.[1]

Evolution of Bank Supervision

Because society and the economy evolve, banking and bank supervision must also evolve in tandem. Just as the failure to evolve makes banking less relevant to the needs of the economy, so does the failure to evolve make bank supervision less efficient in assuring financial intermediation in the economy. Bank supervision must therefore be a dynamic process—not just a static structure applying rigid laws and rules. There can never be a single answer as to what is the best way to regulate banks. The answer changes as circumstances change.

For the past several decades, the economy and the financial services sector have been in constant change, both in the United States and globally. Although the banking industry in the United States is closely regulated, it has also been partially deregulated by fits and starts. Bank supervisors have had to work hard and think hard to keep abreast of these changes. It is fair to say that, since the end of the 1970s, banking has experienced something of a deregulatory revolution. First, there has been interest rate deregulation. This deregulation addressed money market deposit accounts, which developed in response to the securities industry. Even before the recent legislation,[2] there was actual, de facto interstate banking through regional banking compacts. Usury ceilings were eliminated for certain loans. Discount securities brokerage has emerged. The list of innovations—which are remarkable—can go on for quite a while.

As a result of these changes, banks can engage in a far wider range of activities than were possible 20 years ago. This expanding range of activities has placed new and substantial demands on bank supervisors—demands that the supervisory system has not always found easy to meet. For example, supervisors have had difficulties in accurately measuring the extent of bank diversification and the effect of diversification on risk. Moreover, the task of monitoring and assessing off-balance-sheet activities—a somewhat new exercise for supervisors—has proved to be

quite challenging. Supervisors have also struggled to come to grips with accurately measuring an institution's overall risk in a cost-efficient manner. The newest wrinkle is the identification of risk by distinguishing between true hedging and plain, old-fashioned speculation in some of the new instruments.

It is probably fair to say that the biggest challenge in public policy is to restore and maintain a dynamic balance among the business of banking, bank supervision, and the demands of a market economy. To meet the demands of the economy, banks must remain competitive; however, the lesson of recent history is that regulatory and statutory developments that enhance bank powers must proceed hand in hand with supervisory reform. Without adequate supervision, including effectively monitoring bank activities, enforcing regulations, closing institutions, and attending to possible sources of systemic risk, expansion of the banking franchise carries with it implications for the deposit insurer and for the economy as a whole that are potentially unacceptable.

How best to supervise a banking industry whose activities continue to expand has been the subject of much recent debate, with opinions sometimes clustering around two extremes. On one extreme, advocates argue that supervisors can structure the corporate form of financial institutions in a way that insulates not only its banking component but also, as in the U.S. system, the Bank Insurance Fund and even, to some extent, the economy. Advocates on the other extreme argue that only a highly developed supervisory system is appropriate, where supervisors monitor all risks with a view to limiting them effectively. In the real world, supervisory practices fall between these two extremes, and the business of making supervisory policy centers very much on where to draw that line.

The constant change in banking calls into question the effectiveness of any regulatory scheme based primarily on the idea of corporate separation. The illusion of insulating a bank against risk through corporate structure is arguably a concept of theoretical simplicity and elegance, as well as of regulatory minimalism. However, while corporate separation may be a necessary condition of risk management, it is, standing alone, usually not sufficient. In the long run, markets will erode the barriers anyway, and, in the short run, expedience may lead bankers simply to ignore them until something comes along that forces them to take notice.

OCC's Approach

While the OCC certainly agrees that the close monitoring of risk on a daily basis is important, it does not believe that the "hands-on" approach means that supervisory processes should replace bank management.

Rather, the OCC would like to add two refinements that factor bank management into the supervisory equation. The first refinement raises four questions. The initial question is: Is the new activity legal? The next three questions come only after the lawyers have given their opinion on the first question. These three questions are concerned with supervision: Can the risk of new activity be adequately monitored? If so, can monitoring be verified by the supervisors, management, and directors? Finally, can the risk be managed? If the answer to any one of these questions is no, supervisors should take a hard look at the new activity before allowing banks to get involved with it in a larger way.

The second refinement that the OCC has injected into the analysis is the suggestion that bank supervisors should concentrate their attention and their resources on risks with greater potential implications for the economy and the Bank Insurance Fund. These risks usually fall into two categories: the sudden, usually unexpected, collapse of confidence in a significant portion of the banking or financial system; and new product trends and other developments that may affect large portions of the industry and carry substantial safety and soundness implications for the banking industry. Todate, the approach of bank supervisors has been primarily ad hoc and crisis driven. The OCC is striving to change that approach. It is engaged in a variety of initiatives to refocus its supervisory effort to address these risks more consistently and in a more timely manner.

One practical implication for daily examination procedures is to focus on risks depending on the size of a bank. In supervising large banks, the complexity and types of activities of these banks obviously pose greater systemic risk than do the activities of smaller banks. For each of the largest banks, the OCC now develops an individual risk profile, based on all the risks that the bank undertakes. The OCC then tries to determine whether the risks are appropriate for that institution, given its resources, and whether the controls that the institution has in place are appropriate to control those risks. Stable banks in small communities that are engaged in traditional banking activities also tend to have a common risk profile. For these reasons, the OCC will soon begin examining these small banks against a common standard of performance, rather than against the more intensive and intrusive managerial standards that have been used so far.

What does the future hold for banking? The OCC wants to ensure that it holds a system of bank supervision that addresses the growing complexity and technical sophistication of the industry.

11D. Report from the Office of Thrift Supervision

CAROLYN J. BUCK[1]

Several current legal issues concerning the regulation of the U.S. savings and loan industry are the focus of this chapter. To put the issues in context, the evolution of the thrift industry over the past five years needs to be understood. The thrift industry was in crisis only a few years ago. Now, it is profitable but also much smaller. Three areas of regulation mirror various aspects of this evolution. First, the enforcement activity and approach of the Office of Thrift Supervision (OTS) reflect this dramatic shift in the condition of the industry. In 1994, the OTS adopted a new enforcement policy responding to the changes in the thrift industry.[2] Second, amendments were made to the OTS's regulation of mutual savings associations that wish to convert to the stock form of ownership.[3] Again, the amendment was made in response to the changed condition of the industry. Finally, the OTS's regulation of savings associations' uninsured products, such as mutual funds and annuities, is addressed.

OTS's Enforcement Policy

Where did the thrift industry stand before the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)?[4] How has it rebounded? In 1988, there were nearly 3,000 savings and loans with about $1.4 trillion in total assets. That same year, the industry lost $13.3 billion. In 1989, the year that the U.S. Congress created the OTS, the industry lost yet another $6.8 billion. With the expanded enforcement authorities granted by FIRREA, the OTS went to work to clean up the industry. The OTS closed over 700 insolvent savings and loans and successfully pursued those persons responsible for the crisis, including savings and loan officers, directors, lawyers, and accountants. The OTS is in the final stages of that cleanup effort.

The savings and loan industry today is very different from the industry that the OTS regulated in 1989. It is much smaller, and it is now profitable. Between 1988 and 1993, the industry shrank by about 43 percent. At the end of 1993, the industry consisted of 1,669 thrifts with $775 billion in total assets. In the last year or so, this shrinkage has been due to mergers and charter conversions. After four years of losses, the industry has been profitable for four consecutive years, from 1992 to 1995. In 1992, the industry earned $5.1 billion. In 1993, the industry earned another $5 billion. At the end of 1993, 99 percent of OTS-regulated thrifts met the requirements for an adequately capitalized thrift, and 93 percent were well capitalized, as defined by the Federal Deposit Insurance

Corporation Improvement Act.[5] About 93 percent of all the OTS-regulated thrifts were profitable in 1994, compared with only 68 percent in 1989. Part of this is due to favorable interest rates. However, another major reason is the closure of hundreds of shaky and insolvent institutions that were placing competitive strains on healthy institutions.

The enforcement work of the OTS reflects these industry changes. Its enforcement work, which skyrocketed as it responded to the crisis, has tapered off as it worked through the cases associated with failed institutions. With a healthier industry engaged in more traditional thrift activities, there are fewer occasions for taking enforcement actions. In 1990, the OTS completed 348 enforcement actions. In 1991, it completed 876 enforcement actions, an increase of 152 percent. This was the peak of its enforcement activity. In 1992 and 1993, the OTS completed 668 and 299 enforcement actions, respectively. It expects a further reduction in the number of enforcement actions in the coming years.

Responding to these changes in the savings and loan industry, the OTS announced a new enforcement policy in the spring of 1994.[6] It designed the new policy to maximize the agency's efficiency in regulating a sounder and smaller thrift industry by focusing on enforcement actions that will promote a sound industry. The OTS will rely increasingly upon the Resolution Trust Corporation and, after that corporation's closure in December 1995, the Federal Deposit Insurance Corporation (FDIC) to seek restitution from those persons responsible for the dwindling number of thrift failures. Under the new enforcement policy, the OTS gives a high priority to cases involving the recovery of substantial sums in restitution that will have a significant impact on the health of a thrift. The OTS enforcement actions involving closed institutions generally will focus on prohibiting dishonest and untrustworthy individuals from participating in the banking and thrift business or on modifying a person's future practices through a cease and desist order.

OTS's Thrift Conversion Rules for Mutual Savings Associations

Background

The conversion of mutual savings associations to the stock form of ownership is a matter of current interest. Congress, account holders, and consumer groups have voiced significant concerns about the conversion of well-capitalized associations because of the compensation and stock benefits that management typically gets in such transactions. The OTS responded to these and other concerns by amending the regulations governing mutual-to-stock conversions.[7]

Mutual-to-stock conversions are not new. The OTS's predecessor, the Federal Home Loan Bank Board (FHLBB), first adopted regulations allowing mutual associations to convert to the stock form of ownership in 1974.[8] Since then, over 1,000 mutual savings associations have converted to the stock form of ownership, raising about $16 billion in new capital. However, the reasons that prompt associations to convert have changed, and with those changes has come the current controversy.

During the 1980s, most mutual associations were marginally capitalized, and many were insolvent. As a result, the FHLBB changed its regulations to provide significant incentives to management to convert their associations to the stock form of ownership.[9] Many associations availed themselves of these benefits and recapitalized, thereby saving the insurance fund the cost of closing them.

In 1994, however, although most of the 798 mutual associations were healthy, these associations were converting to the stock form of ownership in increasing numbers. This development raises new concerns because the mutual associations obviously have not been converting to meet regulatory capital requirements. Instead, they are raising capital to expand operations or to establish stock benefit plans for management and employees. The public, Congress, and the OTS are concerned about the perception that the management of converting associations has reaped windfall profits.

In addition, the issue has been particularly controversial because some states offer insiders of state-chartered savings banks the opportunity to gain potentially greater benefits and more generous compensation packages than the OTS's rules allow. In 1994, Congress considered legislation to set minimum federal standards for conversions by state savings banks and limitations on management benefits in conversions.[10] Suggestions also have been made that some capital raised in a conversion ought to be used to provide low- and moderate-income housing in the association's community.

Amendments to Thrift Conversion Regulations

To address these and other concerns, the OTS amended its regulations governing mutual-to-stock conversions of insured savings associations to change the regulatory inducements for conversions.[11] The OTS will apply the regulations to all associations, including those with pending applications. The OTS published the amendments to its conversion regulations as an interim final rule because of the critical need to ensure an equitable conversion process while still providing converting associations access to the capital markets.[12]

The OTS's amendments made five key changes to its mutual-to-stock conversion regulations. First, the regulations prohibit the use of the conversion stock itself to fund management stock benefit and recognition plans (MRPs).[13] The FHLBB introduced MRPs when many thrifts were undercapitalized. The purpose of MRPs was to retain good management and to deter hostile takeovers of converting associations by providing an opportunity for management to obtain equity stock in its associations. However, in today's environment, the OTS is concerned that thrift insiders may be tempted to support a conversion to buy significant amounts of conversion stock at the lowest price through various benefit plans. Under the prior regulations, part of the conversion stock was distributed to MRPs and stock option plans. Under the current regulations, management must seek shareholder approval after a conversion is completed to issue new stock and set up an MRP.[14] The OTS believes that this decision should be left to the shareholders, who must weigh dilution of their stock value against the need to reward management.

Second, the local community now has more of a chance to participate in conversions than it did under the prior regulations because eligible "local" account holders have first priority to buy conversion stock.[15] To qualify for the priority, the individual must have been a depositor for at least a year before the conversion application and must live in the converting association's local community or within 100 miles of the association's home or branch office or offices.[16] The regulations define "local community" to include

> all counties in which the converting association has its home office or a branch office, each county's standard metropolitan statistical area or the general metropolitan area of each of these counties, and such other similar local area(s) as provided for in the plan of conversion, as approved by the OTS.[17]

Third, the OTS prohibited the use of "running" proxies in the conversion vote to increase the incentive for the management of converting thrifts to solicit depositors to consider and vote on conversions.[18] An association's management obtains a running proxy to vote the depositor's interest when a depositor opens an account. By prohibiting the use of running proxies, the association's membership should have significantly greater participation in the conversion process.

Fourth, the OTS believes that the integrity of the conversion process rests in large part on the accuracy of the appraised value on which the initial stock price of the association is based. Increasingly, the OTS has found that stock prices have jumped dramatically in the aftermarket. Accordingly, the OTS revised its appraisal standards to require a full appraisal, including a complete and detailed description of the elements that make up the appraisal report.[19] The OTS also has put appraisers and

the thrift industry on notice that the appraisals submitted must accurately reflect the pro forma value of the institution and that, if the OTS finds a significant underappraisal, it will reject the application. Where an appraiser has a pattern of underappraisals, the OTS will consider debarment or other enforcement action.

Fifth, the regulations prohibit a mutual association from converting to the stock form of ownership as part of a merger with, or acquisition by, another entity, except in supervisory cases.[20] The OTS believes that such transactions may be too prone to enrich insiders through favorable employment contracts and other benefit plans provided by the acquiring institutions as inducements to convert. The OTS was so concerned about this phenomenon that it imposed a moratorium on such transactions on January 31, 1994.[21]

The OTS also published a proposed regulation that would require the agency to consider whether the conversion would benefit the convenience and needs of the communities that the association serves.[22] That judgment would include an assessment of how well the association had complied with the Community Reinvestment Act [23] and how the association would use the proceeds of the conversion to meet the needs of the community.[24] Under the Community Reinvestment Act, regulated financial institutions must demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business, including through both credit and deposit services.[25] A converting association is required to submit a business plan as part of its application, and the OTS proposal would have the association address how it would devote resources to lending programs and related customer services to address the needs of their local communities, including low- and moderate-income communities, consistent with the principles of safety and soundness.

The OTS believes that the amendments to the conversion regulations, along with the above-mentioned proposed rule, address the need to balance the interest of account holders with those of management and employees, and the need to give the local community a more meaningful opportunity to participate in all conversions.

OTS's Regulation of the Sale of Uninsured Products

With the increasing competition in the marketplace for offering financial services, insured depository institutions must be more versatile in order to survive. Sales of uninsured products, such as mutual funds, provide benefits in retaining and attracting customers, but they also create risks.

Sales of such products can increase a thrift's competitiveness by enabling it to offer "one-stop shopping" for various financial services. However, there are risks when the customers do not understand what they are buying. Surveys have shown that customers purchasing investment products in depository institutions are more likely to consider the product as "safe" or "insured." Because of inadequate disclosure, misleading marketing, or blind faith that the government will protect them, customers unfamiliar with mutual funds, annuities, and similar products may not understand that the FDIC does not insure these products. Another risk is that the customer will invest in a product without fully understanding its risks. The OTS's concern in this area is heightened because the public is shifting an increasing portion of its savings into mutual funds, in which the customer's risk of loss is substantially higher than in a certificate of deposit or a money market mutual fund.

Thrifts that engage in securities brokerage activities do so indirectly through either service corporations or lease arrangements with third-party broker-dealers. Service corporations may register as broker-dealers themselves, or they may contract with third-party broker-dealers to conduct sales activities. A service corporation may sell uninsured products on the premises of the savings association or off the premises. OTS-regulated entities selling uninsured products are subject to a comprehensive regulatory regime.

The OTS's predecessor, the FHLBB, approved the first application to engage in discount brokerage activities through a service corporation about 12 years ago. Over the years, the OTS developed standards to reduce the confusion that can occur when an insured institution sells uninsured products. For example, sales activities must take place in a separate and distinct area. The physical separation and signs must express visually that the activities are different from the institution's banking activities. The advertising of uninsured products also must be distinguishable from that of the association and may not indicate or imply that the securities are insured or that the insured institution itself is issuing or selling the securities. The OTS does not allow tellers to be involved in the sale of investment products, except to refer depositors who want to discuss investments to the brokerage area.

The OTS also regulates the sale of securities issued by a savings association or its affiliates in the offices of an association. It generally prohibits the on-premises sale of a thrift's own securities or those issued by its affiliates. An exception allows an association to sell equity securities issued by the association or an affiliate in a mutual-to-stock conversion, subject to various safeguards. These safeguards minimize potential customer confusion and the danger of customer deception regarding the nature of secu-

rities sold at a savings association's offices while still preserving an effective means for a savings association to raise capital in the conversion process. For example, there are prohibitions against paying commissions or bonuses to any employee of the association or its affiliates, using common sales areas, and employing fraudulent or misleading advertising. The customer must receive an offering circular and must sign a form stating that he or she knows the security is not insured by the FDIC. In addition, in order to avail itself of the sale of its securities on the premises, the association must be in compliance with all of its capital requirements upon completion of the conversion.

More generally, in February 1994, the OTS and the other federal banking agencies issued an Interagency Statement on Retail Sales of Nondeposit Investment Products to ensure that all depository institutions follow the same standards.[26] The Interagency Statement addresses concerns about customer confusion and safety and soundness. It applies to the sale of retail nondeposit investment products on the premises of thrifts or banks, no matter whether the sales activities are conducted by employees of the institution, its service corporation, or any third-party broker-dealer. The statement also covers sales resulting from a customer referral by the institution to a third party when the depository institution receives a benefit for the referral.

The Interagency Statement sets out the fundamental elements of a sound, well-managed sales program for uninsured products.[27] These elements include the policies and procedures that a savings association should adopt on disclosures to customers, the location of sales, the separation of duties, referral fees, and the training, suitability, and qualifications of sales representatives.

If a thrift decides to sell uninsured products through a third party, the thrift should first conduct an appropriate review of the third party.[28] The thrift should also have a written agreement with the third party that, among other things, should describe clearly the duties and responsibilities of each party and specify that the third party will comply with all applicable laws and regulations.[29]

In addition, brokers should disclose to their thrift customers that the security is (i) not insured by the FDIC; (ii) not a deposit or other obligation of, or guaranteed by, the depository institution; and (iii) subject to investment risks, including possible loss of the principal investment. Disclosures during sales presentations may be oral, but they should be in writing by the time that an investment account is opened. Thrifts should conduct sales of nondeposit investment products in a physical location distinct from the area where they take retail deposits. Thrifts should use signs and other means to distinguish the investment sales area.

These safeguards are less stringent than the rules that the OTS applies to the sale of the institution's own securities. This is because the sale of an association's own securities (or those of its affiliates) on the premises of a savings association carries a greater risk for customer confusion. Therefore, such sales are subject to safeguards beyond those that apply to the sale of securities generally.

Thrifts, thrift service corporations, or affiliates that buy or sell securities for the accounts of depositors and other retail customers must register with the Securities and Exchange Commission and must also be a member of the National Association of Securities Dealers.[30] In addition, in contrast to its treatment of banks, the Securities and Exchange Commission regulates thrifts that are investment advisors to mutual funds under the Investment Advisors Act of 1940.[31]

Conclusion

Those involved in the regulation of the thrift industry face constant change as the thrift industry evolves to keep pace with the times. The problems faced today are very different from the problems faced in the 1980s, when efforts were concentrated on thrift failures and the abuses that led to those failures. Today, the OTS is gearing its efforts to regulate a healthy and much smaller thrift industry in order to ensure that a crisis never happens again.

COMMENT

JOHN S. BAERST

This comment seeks to place some of the important regulatory issues affecting U.S. banking in a wider international policy context. It is unlikely that U.S. regulatory experience is directly applicable to banking regimes in other countries. There are few countries that match the U.S.'s complex bank regulatory structure. Nevertheless, many of the major issues are the same, and an appreciation of the advantages and disadvantages of the U.S. system is helpful.

It is a truism to note that the business of banking is changing rapidly. This is not true everywhere. For example, the pace of change dictated by competition, technology, and cost pressures is greater in the United Kingdom and the United States than, for example, in the Caribbean and Africa, where the traditional forms of banking continue to thrive. Nevertheless, at the international level, banking is generally evolving at a quick pace. This is reflected in the makeup of balance sheets, both on the asset and liability side, and in the way that banks are reorganizing management structures in fundamental ways or combining with other banks or financial institutions.

The health of any banking system, however, is directly affected by the regulatory scheme that applies to it. In the United States, there is dissatisfaction with the present arrangements. The current Administration has given notice of its desire to overhaul the structure of regulatory supervision by creating a single supervisory agency.[1] Others believe that overhauling the structure of banking supervision before considering the restructuring of the whole financial services industry is putting the cart before the horse.

William McDonough, President of the Federal Reserve Bank of New York, has stated:

> [t]he financial services industry today is segmented both in terms of its structure and its regulatory environment. This segmentation increasingly makes less sense as banks, securities firms, insurance companies, and other financial firms compete with one another in offering similar or related products to the same customers. Moreover, the regulation of the financial services industry is a patchwork of market and institutional regulation that reflects not any carefully defined and forward-looking process, but rather a series of ad hoc responses to historical developments, with no central theme. As such, the structure has become outmoded and is badly in need of change.[2]

These are blunt words from a central banker. He goes on to make the second point that this fragmentation, at both the structural and regulatory levels, "has had worrisome effects on the competitiveness of our financial institutions."[3] He speaks here of U.S. institutions, but what he says is applicable elsewhere.

Mr. McDonough's recommendation is that, in light of this extensive fragmentation of the financial services industry and its adverse competitive effects, financial market reform efforts should be based on the needs of the customer and user of financial services. In the United States, for example, this approach might lead to support for banks' ability to underwrite and sell life insurance through their extensive branch networks. Bill Isaac, former Chairman of the Federal Deposit Insurance Corporation, has said that this could lead to reductions in premium costs for consumers of 20–50 percent, because the banks could distribute this product so much more efficiently than life insurance companies.[4]

Regulatory Consolidation

The Federal Reserve and the Department of the Treasury considered a plan of consolidation of the federal banking agencies. There would be benefits and efficiencies from consolidation, without doubt. However, the primary effort should be to reform the function of the financial services market, not the function of the regulators. The principal question should not be who regulates banks, but rather how they are regulated.

The consolidation debate in the United States has nevertheless raised issues that are pertinent to all central bankers. For example, what is the role of the central bank? There is little debate about two core functions, namely, conducting monetary policy and overseeing the payments system. However, what should be the central bank's role in bank supervision?

At the core of the Federal Reserve's opposition to the Administration's proposal was the argument that its core functions would be seriously compromised by the absence of an active involvement in bank supervision. However, not all countries assign a supervisory role to their central banks. This issue of supervision gets tied up with the related issue of central bank independence from political influence. The consensus appears to be that central bank autonomy is the better path,[5] and the European Community, in the aftermath of the Treaty on European Union (the Maastricht Treaty), reflects that direction.[6]

In the United States, certainly, the autonomy of the Federal Reserve is jealously protected. However, there is also a strong sense, rooted in the populist culture of the United States, that the people must control the

banks, and the people, of course, speak through their elected officials. It is easy in these circumstances to find a ready audience for the proposition that bank supervision should be controlled by elected officials (or their appointees), for example, the Department of the Treasury. It is a worthy debate, and a fertile topic for international discussion.

A related question raised by the consolidation debate in the United States is, How many regulatory agencies are needed? Four federal supervisory agencies are represented in this chapter on U.S. banking regulation. Representatives from the 50 state banking authorities, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and any number of other regulatory agencies could also have been represented. Does this plethora of regulators help or hinder banks? Does it increase or reduce the safety and soundness of our financial infrastructure? This, too, is a worthy debate, and the better answers may be counterintuitive.

Initially, the multiplicity of regulators seems to make little sense. However, some argue persuasively that, to cite one example, U.S. savings and loan losses in the 1980s were attributable, in part at least, to the concentration of supervisory and deposit insurance authority in a monolithic, efficient regulator, the Federal Savings and Loan Insurance Corporation. Some proponents of consolidation, however, fear a "competition in laxity," with institutions forum-shopping for the most permissive regulator. Bankers would probably argue that what they have seen recently is rather a "competition in ferocity," with regulators attempting to demonstrate how much more diligent they are than their peers! However, bankers themselves certainly do not want a lax regulatory environment, and the existence of multiple forums for raising regulatory issues has encouraged substantive debate about the best way of balancing regulatory concerns against the business needs of banks. The need for this active balancing of interests is critical to an era of rapid innovation in banking products, such as derivatives.

Deposit Insurance

The availability of deposit insurance and the absence of market discipline supported and arguably encouraged a great deal of the misguided investments by savings and loan institutions in the 1980s. Furthermore, deposit insurance imposes a franchise cost on insured institutions and results in an overly restrictive attitude in the U.S. Congress, which is concerned that regulatory reform may have catastrophic consequences for the insurance funds. Some observers have asked why the scope of insurance accounts should not be severely cut back, and market discipline and supervision allowed to play a greater role in ensuring the safety and

soundness of customers' funds. People today have significant amounts invested in uninsured accounts, such as mutual funds and 401(k) plans,[7] so the concept is not necessarily radical at all. To the extent that insurance coverage can be cut back, the cost of the social franchise can be reduced, allowing banks to compete more effectively with their nonbank brethren. This step would also enable Congress to take a less suspicious view of product innovation.

Foreign Bank Supervision

U.S. regulators are committed to the principle of national treatment. They usually bend over backward to give foreign banks a fair shake. What is critical with banks operating across borders is the exchange of information, so that a level of confidence is built concerning the ability of diverse regulatory regimes to adequately police their banks. No central bank has a monopoly on best practice, and what is to be expected is a continuing convergence toward standards of best practice.

One question that remains at the forefront is, How can branches of banks outside their home countries best be regulated? In the past few years, it was proposed by some that foreign banks should be required to convert their U.S. banking operations into separately capitalized subsidiaries. The issue was thought to have been put to rest by a study by the Department of the Treasury and the Federal Reserve supporting the branch concept.[8] However, the issue came to the fore again in the Senate's version of the legislation permitting interstate banking, which would have required foreign banks to act through subsidiaries if they wanted to take advantage of the new legislative authority.[9] The very arguments supporting the ability of U.S. banks to branch nationwide, which have now been accepted by Congress, support the rationale for allowing international banks to branch worldwide. These persuasive arguments are accepted by most regulators.

It is nevertheless the case that branch operations in host countries pose many conceptual issues. In the United States, for example, the regulatory paradigm is the bank holding company, and direct branch operations do not always match that paradigm easily. Regulators at both the federal and state levels are making efforts to come to grips with these issues, such as how to handle the insolvency of a U.S. branch of a foreign bank. Many solutions require international dialogue. For example, what approach is best for supervising a branch? In the European Community, under the Second Banking Directive, the host country defers significantly to the home country regulators with respect to branch operations.[10] In the United States, in contrast, regulators are developing specific guidelines

for U.S. branches of foreign banks to follow in conducting their operations. There is definitely a divergence in approach here. Furthermore, what is a branch? U.S. regulators tend to treat branches as stand-alone entities, which are expected to contain within themselves internal control systems similar to those found in U.S. banks. However, the control systems may exist in the home country outside the branch, even though they effectively reach the branch. Credit decisions, for example, may be made at the head office or in a non-U.S. office that has overall credit control over a multinational company. U.S. regulators, however, require that the credit decision be within the branch's control, as their supervisory oversight or responsibility does not reach the offshore point.

It is very important that the branch concept be supported worldwide, but an active dialogue on the consequent supervisory issues is essential. That dialogue falls properly within the central bank lawyer's sphere of responsibility. In addition, bankers should continue to be included in the discussions because of the significant practical consequences of the resolution of this issue.

Chapter 12

Banking Reform in the United States

FÉ MORALES MARKS

Introduction

When the current Administration took office in 1993, the economy was in the midst of a slow, fragile recovery. Since then, the recovery has been put on a secure basis. It is secure because a credible long-term deficit-reduction program was put in place. It is secure because world markets have been opened. It is secure because measures have been taken within the banking sector to spur increased lending.

Evidence of success can be seen in the performance of American businesses. Their balance sheets are far stronger than they have been in recent years. Corporate profits were up 12 percent in 1993, even after a number of large write-offs. Long-term debt has been replacing short-term debt. Corporations began issuing equity again so that they could pay down debt. Debt-to-equity ratios on a market value basis reached their lowest point in 20 years. Business failures declined. Further evidence can be found in the profitability and improved financial standing of national banks, as well as in the banking system's increased lending.

The Administration's economic plan will continue to fortify the nation's recovery. In 1994, it was shown that the Government can take tough, painful actions to cut costs. This process of making tough choices will continue. With respect to the Administration's banking agenda, some issues were easy to deal with, such as the passing of legislation on interstate banking.[1] Some issues will face difficult obstacles and pose tough choices, particularly with respect to regulatory consolidation and derivatives.

Fair Trade in Financial Services

The conclusion of the Uruguay Round negotiations and bilateral discussions on financial services with a number of countries reaffirm the view that passing the Fair Trade in Financial Services Act is essential.[2] The bill would provide the Secretary of the Treasury, under the direction of the President and in consultation with other executive branch and regu-

latory agencies, the power to withhold the possibility of future expansion and benefits to financial firms based in nations maintaining restrictive barriers to trade in financial services.[3]

The objective of financial services has been and remains to obtain substantial market access and national treatment for U.S. banks, securities firms, insurance companies, and other financial institutions. The United States intends to negotiate intensively to achieve further liberalization in financial markets. The goal will be to open foreign markets, not close U.S. markets. The Fair Trade in Financial Services Act is an essential component of the strategy to continue multilateral negotiations to open foreign financial markets to U.S. financial institutions.

The United States will approach these negotiations in a reasonable and pragmatic manner. Foreign financial firms can make important contributions to the development of host countries. They bring additional capital, together with financial and managerial expertise. At the same time, host countries have legitimate concerns, including the preservation of a strong indigenous financial base, the avoidance of overbanking in relatively small markets, and the avoidance of market disruption. In addition, emerging market economies share the need to ensure the safety and soundness of their financial systems.

As has been noted by some observers, liberalization is a process that does not happen with the flip of a switch; it may take time. Therefore, the United States is prepared to consider transitional arrangements that provide breathing room for domestic firms to adjust to greater competition. The United States is willing to work with those countries that are willing to liberalize. This consideration leads to the following three guidelines for financial services negotiations. First, in seeking market liberalization, the United States is looking for agreements that provide reasonable access to foreign markets and national treatment for U.S. banks. The United States is prepared to provide full market access and full national treatment to countries that give American firms satisfactory access and national treatment. Second, the Department of the Treasury will take a constructive approach that, as negotiations continue, will keep U.S. markets open by "grandfathering" the existing operations of firms already established in U.S. markets. Third, the objective remains an agreement that opens markets on a multilateral basis. However, the United States cannot accept a situation in which other nations retain the right to discriminate against American firms while their firms are permitted to expand in the U.S. market.

The Department of the Treasury's continuing effort to open foreign financial markets will yield many economic and financial benefits for the United States and its trading partners. Efficient and open financial ser-

vices industries help integrate domestic and regional economies within the global economy. Greater market access to financial services is absolutely critical for creating economic growth for all nations. The Fair Trade in Financial Services Act would provide the incentives needed to open more markets abroad.

In open financial markets, firms from the least open countries enjoy the same benefits as firms from the most open. Home countries of the former group do not perceive a need to open to U.S. firms. This asymmetry works against the United States in the negotiating context. The Fair Trade in Financial Services Act could help to redress the imbalance by withholding the option of future expansion and benefits from foreign financial firms.

The United States seeks the additional authority of the Fair Trade in Financial Services Act only to open markets. The United States will not use the legislation for protectionist purposes. The Administration will be very prudent and cautious in imposing sanctions, and it will exercise its authority in a manner consistent with, and supportive of, the commitments that it may ultimately make pursuant to the General Agreement on Trade in Services.[4] Finally, the Administration will protect the existing operations of foreign financial institutions already established in the United States.

Interstate Branching

Geographic restrictions are a needless burden. Clearly, they were among the least defensible of the U.S. banking laws. In late 1993, then Secretary of the Treasury Lloyd Bentsen announced the Administration's support for a basic approach to removing these geographic restrictions and allowing banks to establish interstate branches.[5] Both houses of Congress responded to Secretary Bentsen's announcement by passing interstate banking legislation, the Riegle-Neal Interstate Banking and Branching Efficiency Act.[6]

The geographic restrictions on commercial banks originated in the earliest days of American banking to protect banks from competition and preserve local markets for local banks. However, these restrictions warranted reassessment because financial markets and institutions, and the economy itself, have evolved dramatically since then. Under the Riegle-Neal Interstate Banking and Branching Efficiency Act, the Federal Reserve is authorized to approve an application by a bank holding company to acquire a bank in any state without regard to whether this is prohibited under state law. This authority is subject to certain limitations, including a concentration limit that restricts the percentage of deposits

that a banking organization controls on both a national and state basis. The new law also authorizes the federal banking authorities to approve mergers between banks with different home states, without regard to whether this is prohibited under state law (subject to a state option described below). Certain restrictions on branching acquisitions and mergers apply. The law authorizes either the acquisition of a bank in another state or, if a state expressly permits, the acquisition of a single branch without the rest of the bank. States may, before June 1, 1997, opt out of interstate mergers (although not in respect of distressed banks). In addition, the law permits federal regulators to authorize banks to open new branches across state lines if the receiving state permits this.[7]

Benefits of Removing Geographic Restrictions

The former framework of geographic restrictions was no longer appropriate for several reasons. First, modern banks operate beyond local markets. Second, they compete with nonbank institutions that face no similar geographic restrictions. Third, by removing these restrictions, the safety and soundness of the banking system could improve. Finally, by removing geographic restrictions, banks can structure themselves more efficiently, which could ultimately permit banks to make more credit available to businesses and individuals.

Operating Realities

Banking organizations can no longer be defined in terms of the limited services and facilities considered appropriate in past generations. New realities are evident on both sides of the banking balance sheet. For example, on the liability side of the balance sheet, banks fund themselves not only with traditional (local) retail deposits, but also with large negotiable certificates of deposit, foreign deposits, Eurodollar borrowings, Federal Reserve funds, repurchase agreements, and debt and equity issues, among others. These funding transactions can involve local, regional, national, and international financial markets.

On the asset side, large banks have for many years reached for business opportunities beyond local markets. Real estate, commercial, foreign government, and securitized loans, as well as various types of loan participations, typically require involvement in nonlocal markets. The same is true of such other services as money management, cash management, electronic funds transfers, private placements, credit card distributions, foreign exchange dealing, and various risk-management activities.

Furthermore, geographic restrictions keyed to local markets proved porous. They applied to brick-and-mortar branches, but not to loan pro-

duction offices or Edge Act corporations, or to mortgage finance, consumer finance, or securities brokerage subsidiaries—which banks and bank holding companies may establish anywhere, without regard to state boundaries or intrastate branching restrictions. Moreover, numerous bank holding companies have used grandfather rights, emergency acquisitions, and evolving state laws to establish extensive, although unwieldy, interstate banking networks.

Competition with Nonbank Institutions

Many nonbank financial institutions offer products that compete directly with bank services. Yet these nonbanks operate more efficiently because they face no geographic restrictions. Federally chartered thrift institutions can branch nationwide. Federal credit unions can do likewise, as long as their members share the requisite common bond. Mutual funds, many of which offer check-writing and other consumer conveniences, have become the most notable substitute for insured deposits. Securities firms also compete for savers' funds by offering cash management accounts, with check-writing and credit card features, through large networks of geographically dispersed offices. Insurance companies provide banklike savings services nationwide through insurance policies with redeemable cash value, and they compete directly with banks in making large commercial and real estate loans. Other major competitors that operate free from geographic restrictions include consumer, business, and sales finance companies; mortgage companies; the captive finance firms of automobile and appliance manufacturers; and retail credit grantors.

On balance, geographic restrictions on banks outlived their usefulness and no longer reflected bank practice or competition. They required banks to organize themselves in cumbersome and inefficient ways to compete.

Safety and Soundness

The relaxation of geographic restrictions will tend to promote a safer and sounder banking system. Allowing banks to diversify their assets geographically allows them to diversify their income streams, making them more stable than assets from any one geographic area. Geographically limited banks have earnings more susceptible to the vagaries of local market cycles, which can make them more likely to encounter difficulties. Indeed, regional economic downturns figured prominently among the causes of many of the bank failures of the 1980s.

Geographic diversification also facilitates developing a strong retail deposit base, which represents additional protection against failure.

Historically, banks heavily dependent on purchased funds have shown heightened vulnerability to rapid deposit outflows. Banks with large, geographically diverse retail deposit bases have been better able to avoid or withstand liquidity problems. Finally, to the extent that interstate consolidation reduces banks' operating costs, it helps them build or maintain capital, directly contributing to overall safety and soundness.

Efficiency and Cost Savings

Many banks and bank analysts argue that consolidating banks into branches across state lines would yield major cost savings, as banks would eliminate duplicative functions and reduce expenses. While the extent of the savings may vary from one bank to another, many banks can arguably realize efficiencies. Moreover, the fact that savings may vary across banks in no way warrants denying banks an opportunity to realize these savings.

Interstate Banking and Foreign Banks

No other nation has geographic restrictions such as those that existed in the United States, and most have moved far ahead of the United States on this issue. For example, the Second Banking Directive of the European Community (EC) established a single banking license, valid for banks established in the EC to establish branches and to provide cross-border banking and securities services.[8] In addition, the Second Banking Directive permits those banks from third countries with EC subsidiaries to obtain the same benefits of liberalization that are provided to direct branches of EC-based banks.

In the spirit of the Second Banking Directive and the general policy of open markets, the Department of the Treasury has worked very hard to ensure that the benefits of interstate banking also apply to banks based outside the United States. The Department of the Treasury has consistently supported efforts in the U.S. Congress to assure national treatment for foreign banks. The United States cannot in good conscience press for open markets abroad if impediments for others to enter the U.S. markets exist.

Regulatory Consolidation

With the advent of interstate banking and the increasingly international nature of financial institutions, the United States will have to modernize its regulatory structure and modify some of its banking rules to take into account new banking activities. With respect to modernizing the regula-

tory structure, the current Administration has proposed a consolidation of the four federal banking agencies.[9]

The Department of the Treasury believes that consolidation of the federal banking agencies presents a unique opportunity to rebuild a part of America's economic infrastructure that has become badly outmoded, and to make the Government more effective and efficient. The current federal bank regulatory structure is convoluted, places a serious drag on the nation's banking industry and the economy in general, has failed to effectively protect the stability of the banking system, and ill serves the financial services needs of the American people.

Structure of the Current Regulatory System

Today, four different federal agencies regulate and supervise depository institutions that are insured by the Federal Deposit Insurance Corporation (FDIC). First, the Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises national banks. Second, the Board of Governors of the Federal Reserve System and the Federal Reserve banks (referred to collectively as the Federal Reserve) regulate and supervise bank holding companies and state-chartered banks that are members of the Federal Reserve System. Also, the Federal Reserve, as well as the OCC, has certain responsibilities for regulating and supervising foreign banks' U.S. operations and U.S. banks' foreign operations. Third, the FDIC, in addition to insuring deposits, regulates and supervises state-chartered banks that are not members of the Federal Reserve System.[10] Finally, the Office of Thrift Supervision (OTS) charters, regulates, and supervises federal savings associations, and regulates and supervises savings and loan holding companies and state-chartered savings associations.

Trapped in this maze of bureaucracies, most banking organizations are subject to redundant demands, overlapping supervision, and often inconsistent regulation by two, three, or even all four of the federal regulatory agencies. The system has been described as a "patchwork structure of regulation consisting of a battery of contradictory agencies which have often reduced supervision of financial institutions to the lowest common denominator among their conflicting positions."[11]

Given its duplication, waste, and confusion, this system would be ripe for reform even if it had a strong record of preserving bank safety. But it does not. The United States not so long ago emerged from its worst financial crisis since the Great Depression. One of the lessons of that crisis is that the bank regulatory system is cumbersome and antiquated. It did not adequately anticipate or help resolve the recent crisis.

Under the Administration's regulatory consolidation proposal, bank and thrift resources that are dedicated to coping with inconsistent and redundant regulation under the current scheme could be redirected to productive uses, such as meeting the needs of customers and the demands of global competition. In addition, the regulatory system proposed by the Administration would be more effective than the current patchwork of regulators in protecting the safety and soundness of the banking system.

Structure of the Administration's Consolidation Proposal

Specifically, the Administration's proposal would combine the regulatory and supervisory functions of the OCC, the Federal Reserve, the FDIC, and the OTS into a new independent agency, the Federal Banking Commission (FBC).[12] It would attack redundancy and waste in government by realigning the banking and thrift regulators according to their core functions of bank regulator, central bank, and deposit insurer.

Under the plan, the banking regulatory system would consist of a strong, stable three-part structure based upon core agency functions that complement each other. The FBC would regulate and supervise all federally insured banks and thrifts, all bank and thrift holding companies, U.S. banks' foreign operations, and foreign banks' U.S. operations. The FBC also would charter national banks and federal savings associations. The FBC thus would carry out all the functions currently exercised by the OCC and OTS, as well as the FDIC's functions as primary federal overseer of state nonmember banks and the Federal Reserve's functions as primary federal overseer of bank holding companies, state member banks, and foreign banks. The core functions of the Federal Reserve and FDIC would not be disturbed. (This is an important component of the Administration's plan that has been much misunderstood.)

Nothing in the Administration's proposal would affect the Federal Reserve's independence, deprive it of needed information, or hamper the performance of its essential functions. The Federal Reserve, as the nation's central bank, would continue to conduct monetary policy, administer the payments system, set bank reserve requirements, and provide liquidity through the discount window. It would retain full rule making and other authority necessary to carry out those responsibilities. It would still participate in market oversight of government securities dealers and brokers as part of its responsibilities for open market operations. In addition, it would participate in FBC examinations of certain banking organizations that the Federal Reserve concludes it needs to examine because of the relationship of those operations to the Federal Reserve's

monetary policy, payments system, or discount window functions. This includes examinations of national banks.

The Federal Reserve's participation in examinations would be meaningful. From the nation's 20 largest banking organizations, the Federal Reserve would select annually for joint examinations up to 10 banking organizations (whose subsidiary insured depository institutions could, in the aggregate, hold up to 25 percent of the total assets of all FDIC-insured depository institutions). The Federal Reserve and the FBC would jointly examine those banking organizations. In addition to authorizing the Federal Reserve to examine a cross-section of both large and small banking organizations jointly with the FBC, the plan gives the Federal Reserve backup enforcement authority to correct actual or potential safety and soundness problems at the nation's 20 largest banking organizations.

The FDIC would continue to insure deposits at all federally insured banks and thrifts. It would continue to grant, suspend, and terminate deposit insurance. It would be able to conduct its own special examinations of insured institutions where necessary to protect the deposit insurance fund and take "backup" enforcement action to stop unsafe practices if the FBC did not do so. The FDIC also would retain its current role as deposit insurer, overseeing activities of state banks and thrifts that could pose risks to the insurance funds and carrying out promptly corrective action statutes (for example, helping determine whether a critically undercapitalized institution should remain open), and it would retain responsibility for resolving bank and thrift failures at the least cost to the insurance funds.

The Federal Reserve and the FDIC would have full access to bank and thrift supervisory information, so they would be able to make independent judgments on matters bearing on their core functions. The FBC would be required to provide the Federal Reserve and the FDIC with timely and accurate information on the condition of the banking and thrift industries and on individual depository institutions.

In essence, the Administration's proposal creates a three-part structure of banking industry oversight. Like the legs of a sturdy three-legged stool, each agency would have its own important, independent functions and strengths, and each would complement the others to create a stable, effective regulatory structure. The new regulatory structure would oversee the safety and soundness of the banking industry and guard against risks to that system far more effectively than the current mix of regulators.

Benefits of the Administration's Consolidation Proposal

The Administration's proposal for consolidating the federal banking agencies has many undeniable benefits. It would improve the quality of the regulation and supervision of the U.S. banking system and eliminate inconsistent interpretations of the same laws and rules. It would increase the accountability for regulating financial institutions, providing a focal point for administration, congressional, industry, and public concerns. The proposal would eliminate the potential conflicts of interest inherent in the present system and ultimately reduce government and industry expenses, benefiting banks, thrifts, consumers, and the economy as a whole.

Improved Supervision

Because each banking agency is responsible for supervising just a part of the financial services industry, the supervision of most banking organizations, including virtually all of the nation's largest organizations, is conducted by more than one federal agency. Each agency examines and supervises only a part of the typical banking organization. For example, a holding company that controls a national bank, a state nonmember bank, and a thrift is regulated by all four of the federal banking agencies. The Federal Reserve supervises the holding company, the OCC supervises the national bank, the FDIC supervises the state nonmember bank, and the OTS supervises the thrift. As of September 1993, there were 28 holding companies, with $743 billion in assets, in exactly this position. In these and similar instances, each regulator relies upon the other regulators for information regarding the parts of the banking organization for which it is not responsible. Accordingly, there are thousands of cases where the United States's current system requires a separate bank holding company regulator that does not regulate any of the holding company's subsidiary banks or thrifts.

This fragmented approach to supervising and examining a banking organization ignores the modern realities of how banking organizations operate and hinders the agencies from obtaining a complete and accurate picture of what is really happening. Transactions between related entities that are supervised by different regulators can escape adequate scrutiny if no one agency sees the organization as a whole. Supervision is particularly difficult when the responsibility is divided among three or four agencies.

With the current bank regulatory system, any one regulator may see only a limited piece of a dynamic, integrated banking organization, when a larger perspective is crucial both for effective supervision of the partic-

ular organization and for an understanding of broader industry conditions and trends. It would be difficult to argue that the current, segregated approach to regulation is the most effective way to guard against risk to individual banking organizations or to the banking system as a whole.

Under the Administration's proposal, banks and their holding companies and other affiliates would be supervised as a unit, thereby eliminating inefficiencies and potential blind spots in supervisory oversight, and providing the FBC with multidimensional perspectives on individual banking organizations and the banking industry.

Elimination of Inconsistent Regulation

The Administration's proposal would eliminate inconsistencies in bank regulation. Because banks and thrifts would no longer suffer or benefit from the different application of enforcement standards or other policies of the separate agencies, consolidation would end the practice of "regulator shopping," where institutions choose their charters in order to come under the jurisdiction of a more lenient federal regulator. Instead, charter decisions would be made on their merits, as regulators would no longer be inhibited from taking the most appropriate action by the knowledge that the action could prompt an institution to engage in regulator shopping.

Beyond the problem of regulator shopping, the multiplicity of regulators creates countless headaches, particularly for banking organizations that must reconcile inconsistent regulatory decisions, substantive standards, and procedural requirements applied to their subsidiary organizations by different regulators. The agencies sometimes apply different rules to similar situations and sometimes apply the same rules differently. The proposal would provide a comprehensive and coordinated mechanism for enforcing applicable laws and regulations.

In addition, as banking regulations would be consolidated into one agency, there would be no need to coordinate policies and regulations among different agencies. These efforts at coordination can take months, indeed years, and involve hundreds of people in complex negotiations. In the end, the efforts may not succeed. In recent years, it has sometimes literally taken an act of Congress to get the agencies to coordinate their actions.

With consolidation, the long delays inherent in the interagency coordination process would disappear, allowing a more rapid resolution of significant policy questions. The quality of regulatory decisions and rule making also would likely improve because agencies with different (and

sometimes competing) agendas would no longer have to negotiate and settle for compromise positions.

Increased Accountability

Consolidation of the federal banking agencies would increase the accountability of the regulators to the public. Today, when complaints arise in the industry, the various agencies can sidestep public and political accountability by pointing fingers at each other. Any regulator who assumes responsibility has only limited ability to influence the overall structure and effectiveness of the federal supervisory system. With a consolidated agency, the Congress, the public, and the industry would know where to direct their questions and concerns and from whom to expect action.

The structural flaws of the current system are not theoretical. In the mid-1980s, the warning signs were clear that banks had overinvested in commercial real estate loans, but the regulators could not agree on a unified strategy to address the problem. This failure to take responsibility and act contributed to the enormous financial losses.

The Government and the banking industry would not be the only ones to benefit from a single, accountable agency. The public, which cannot afford banking lawyers to guide them through the existing regulatory maze, would be able to go straight to the FBC with their comments and complaints. Few consumers now know which federal agency they should contact if they have a problem with their bank or thrift. A single regulator would resolve this issue.

Elimination of Potential Conflict of Interest

The Administration's proposal addresses the inherent conflicts of interest and focus that can arise when an agency has more than one core function. Under the current structure, the Federal Reserve Board, as the central bank, and the FDIC, as the insurer of bank deposits, both face such potential conflicts when they wear their bank supervisory hats.

The Federal Reserve's primary mission is to oversee monetary policy, but it also has bank supervisory duties. There are at least three ways in which monetary policy and supervisory functions may conflict: first, bank examinations may conflict with countercyclical monetary policy; second, the two functions compete for the time and energy of policymakers, with bank regulation always taking a backseat to monetary policy; and third, implementation of both functions by the same agency may involve con-

flicts of interest, with the result that the goals of one function are subverted to those of the other.

As former Federal Reserve Board Vice-Chairman J.L. Robertson stated:

> [I]n appraising the soundness of loans or investments, bank examiners should never be obliged to switch from rose-colored glasses to black ones, and back and forth again, in an effort to implement the monetary policy of the moment.[13]

Banks and the businesses that they deal with need consistent direction and advice—not policies that would be tugged by macroeconomic cycles. Regulatory and supervisory policy should be a matter of safety and soundness.

The FDIC's primary role is to insure bank deposits, so it also faces potential conflicts when it supervises banks. The FDIC, as insurer, has incentives to resist banking innovations if the insurance fund is solvent, even if these innovations may be exactly the changes that banks need to pursue to be responsive to evolving customer needs and to ensure a healthy future. However, if institutions, particularly large ones, or the insurance fund nears insolvency, the insurer has incentives to forbear from adequately fulfilling its supervisory role.

Agencies that are forced to wear two hats still have only one head. Conflicts of responsibilities and focus are inherent in these situations. By realigning bank and thrift regulators according to their core functions, the proposal would eliminate these potential conflicts.

Reduction in Government and Industry Expenses

The proposal is an important component of the Administration's overall agenda of reinventing government—creating a government that works better and costs less. Under the current system, each of the four federal banking agencies has its own team of examiners, its own bureaucracy, and its own regulations. Consolidation would streamline the U.S. Government by eliminating this overlap.

The estimated administrative cost savings to the Government from agency consolidation runs somewhere between $150 Million and $200 million a year after initial transition costs, even apart from any fundamental changes in the examination process. Direct savings to the banking industry would be substantially greater.

In 1992, the Federal Financial Institutions Examination Council, chaired by then Governor John LaWare of the Federal Reserve Board, estimated that the cost of complying with banking regulations may be as

high as 14 percent of banks' noninterest expenses.[14] Given bank and thrift noninterest expenses of $156 billion in 1992, the cost of complying with banking regulations may be as high as $22 billion annually. These costs are passed on, in one way or another, to customers.

If the Administration's reorganization proposal were to reduce this burden by only 5 percent, it would result in savings of over $1 billion per year to the industry. These are cost savings that eventually could be translated into loans to businesses and homeowners and benefits to consumers. Banks would be able to turn from filing forms to lending, as they would have only one regulator to deal with instead of two, three, or four, and only one set of examinations and compliance reports to complete instead of many. Current trends in the financial services industry make the reduction of compliance costs imperative. Competition from other providers of financial services is shrinking profit margins in banking, making it increasingly important for banks and thrifts to minimize expenses.

Arguments Against the Consolidation Proposal

The arguments opposing the Administration's plan assert that the Federal Reserve must retain a large role in banking regulation and supervision. Several of these arguments rely on considerations relating to "systemic risk" or the "payments system." However, it is submitted that, when probed, the arguments are not persuasive. The Administration's proposal was carefully crafted to take account of the Federal Reserve's legitimate needs and concerns.

The Federal Reserve is concerned about its access to the bank supervisory process, which it believes necessary to conduct monetary policy and control systemic risk. It also has sought assurances that it would retain the powers necessary to manage the discount window and payments system. The Administration's proposal satisfies all of these concerns, providing the Federal Reserve with sufficient bank supervisory capabilities and preserving all of its core central bank powers and responsibilities.

Opponents of consolidation argue that the integrity of U.S. monetary policy and the stability of the financial system depend on the Federal Reserve's maintaining a role in banking supervision. The Administration's proposal fully addresses this concern and actually expands the scope of the Federal Reserve's supervisory authority over the banks most related to these functions.

Today, the Federal Reserve directly supervises only 7 percent of all FDIC-insured depository institutions and only 15 percent of the nation's bank and thrift assets. Most of the banks under its supervision are small,

with an average size of less than $45 million in assets. The Federal Reserve supervises only 12 of the 52 U.S. banks with assets of more than $10 billion, and only 5 of the 20 largest institutions. For information concerning the remaining 93 percent of the depository institutions, including most of the largest organizations, the Federal Reserve relies on reports prepared by the other banking agencies, namely, the OCC, OTS, and FDIC.

Some contend that it is unrealistic and unduly hopeful to believe that the knowledge and expertise that the Federal Reserve needs to do its job properly can be gained from studying examination reports prepared by another agency. However, this is exactly what the Federal Reserve does today. Review of Federal Reserve supervisory practices at the largest national bank holding companies reveals that the Federal Reserve relies heavily—indeed, almost entirely—on the examination reports prepared by the OCC for information regarding national banks and their subsidiaries. The Federal Reserve does not audit or otherwise probe behind the conclusions of the OCC reports. The OCC's conclusions regarding the national banks are adopted wholesale and often incorporated into the Federal Reserve's annual reports on bank holding companies. If the Federal Reserve can rely on the examination reports prepared by the OCC and the other federal banking agencies for the bulk of the information that it obtains regarding the banking industry, it is hard to see why it cannot rely on the more comprehensive reports that would be prepared by the FBC. The contention that sound monetary policy rests on the Federal Reserve's continued direct supervision over a small subset of the banking industry is thus difficult to justify.

Moreover, much of the Federal Reserve's supervisory activities in connection with bank holding companies with national bank subsidiaries is duplicative of the work already performed by the OCC. This duplication results from the way that modern banking organizations are structured and operated, and from the different supervisory approaches taken by the Federal Reserve and the OCC.

Most banking organizations are structured along functional lines rather than according to charter type. For example, a banking organization may engage in securities trading through its bank and nonbank subsidiaries. As the activities of these various entities often are highly integrated, a proper examination of most modern banking organizations must encompass the bank's interactions with its nonbank affiliates, not just banking or nonbanking operations taken in isolation. For this reason, the OCC looks at holding company nonbank subsidiaries in connection with its examination of national banks. The Federal Reserve frequently repeats

part of the process, however, when it looks at the same subsidiaries in connection with its inspection of holding company nonbanking entities.

Similarly, because the procedures and controls of the banking and nonbanking subsidiaries often are the same, it is not necessary to examine them twice—first for the bank subsidiaries and then for the nonbank subsidiaries. Nonetheless, under the current system, this is exactly what happens. The OCC examines the procedures and controls of the national bank subsidiaries, and the Federal Reserve inspects the same procedures and controls in connection with its review of the holding company's nonbank subsidiaries.

The Administration's plan satisfies the needs articulated by the Federal Reserve for a significant supervisory role and, at the same time, dramatically reduces the duplication and eliminates the inconsistency inherent in the current supervisory system. By allowing the Federal Reserve to participate in, and even direct, joint examinations, the proposal would give the Federal Reserve a "hands-on" role involving up to 30 percent of the nation's bank and thrift assets—double the amount under its present direct supervision.

The assertion that the changes proposed to the Federal Reserve's bank regulatory responsibilities and the redefinition of its bank supervisory authority would so reduce the Federal Reserve's "clout" that it would become incapable of implementing monetary policy is difficult to substantiate. While any reform of the banking system must inevitably shift responsibilities, the Federal Reserve would lose only a fraction of its powers and responsibilities and would gain others. It would retain all of its core functions and powers, including the formulation of monetary policy, operations in the open market, establishment of bank reserve requirements, management of the payments system, and operation of the discount window. It would lose only its rule-making authority over state member banks and bank holding companies. Furthermore, no banker would ever ignore the local Federal Reserve district bank president, let alone the Federal Reserve Board in Washington.

Under the proposal, the Federal Reserve would continue to have complete, independent authority to regulate and supervise the payments system. Notwithstanding, certain critics oppose agency consolidation on the basis that it could impair the Federal Reserve's ability to manage this system. The Federal Reserve does not need bank supervisory powers in order to perform any of its responsibilities in connection with the payments system. No evidence suggests that the Federal Reserve conducts hands-on supervisory examinations of individual banking institutions that are not under its primary supervision with regard to this system.

Some observers also have asked whether the Federal Reserve needs bank supervisory powers to operate the discount window. Like the Federal Reserve's oversight of the payments system, its management of the discount window (where Federal Reserve banks make short-term, secured loans to financial institutions) does not depend upon the Federal Reserve's bank supervisory jurisdiction. As noted above, the Federal Reserve does not examine the vast majority of institutions that borrow from the discount window, and no evidence indicates that the Federal Reserve conducts hands-on supervision of individual institutions with respect to their use of the discount window. Currently, the Federal Reserve lends only on a fully secured basis, and traditionally it accepts only the highest-quality collateral, for example, government securities. It does not take knowledge about banking to evaluate the quality of readily marketable government securities. Also, it does not take the skills of an entire bank examination agency to be a fully secured lender.

The term "systemic risk" is frequently referred to in statements made by opponents of the Administration's consolidation proposal. Systemic risk refers to the likelihood of a sudden, unexpected, and widespread collapse of confidence in the financial system, with a potentially large effect on the economy in general. Systemic risk can be triggered by a wide variety of events and can originate either inside or outside the banking system. One example of a systemic event occurred in October 1987, when the Dow Jones stock market index dropped almost 600 points in a single day. What made this a potential systemic crisis was the possibility of contagion or other spillover effects. Virtually every aspect of the financial system was affected by the 1987 stock market break, including banks and thrifts, insurance companies, investment banks, finance companies, pension funds, mutual funds, and various government-sponsored agencies. The markets where financial instruments trade, such as the stock markets, markets for public and private debt, futures exchanges, international markets, and over-the-counter markets, were also affected.

Consolidation opponents caution that any reduction in the Federal Reserve's banking regulatory responsibilities would decrease its ability to anticipate and cope with potential systemic financial problems. This assertion is not correct. The financial market encompasses far more than the state-chartered member banks that the Federal Reserve directly supervises today. As previously noted, it includes stock markets, bond markets, commodities markets, the insurance industry, and many other components. Today, the Federal Reserve is the principal supervisory authority for only a small fraction of the overall market. The Securities and Exchange Commission, the OTS, the OCC, the FDIC, the Department of the Treasury, and additional federal agencies, together with state bank and insurance regulators and the supervisory authorities in other coun-

tries, are all responsible for overseeing portions of this market. The Federal Reserve does not have and has not argued that it needs or wants supervisory authority over these other institutions or markets to deal with systemic risk. Recent events suggest that this arrangement works well. Thus, it appears that the Federal Reserve is satisfied that these other supervisory authorities and the information that they collect and supply are sufficient for it to contain systemic risk. It is difficult to understand why coordination by the Federal Reserve and the FBC would not assure access by the Federal Reserve to whatever information it needs about the banking industry.

The consolidation proposal also would not affect the Federal Reserve's ability to react to a systemic shock. The Federal Reserve responds to systemic crises by supplying liquidity through open market operations, discount window lending, or some combination of the two. In the case of open market operations, the Federal Reserve relies on the market to allocate the new liquidity. No Federal Reserve bank supervisory capability is required. The effectiveness of this approach has been demonstrated in a number of recent cases, such as the failure of Drexel Burnham Lambert in 1990 and the stock market break in 1987.

Not every financial market disturbance constitutes a systemic risk. In fact, in the post-Depression era, truly systemic events have been relatively rare. Furthermore, the possession of bank supervisory capabilities would not likely help the Federal Reserve to anticipate the type of market shocks that trigger systemic events, such as extreme stock or commodity price movements or regional recessions. In any event, the Federal Reserve would continue to have significant bank supervisory powers under the Administration's plan.

The need to restructure the federal banking and thrift regulatory system has grown more urgent over the past several decades, as distinctions among depository institutions have blurred and the regulatory system has grown not only more costly and complex, but also less efficient and responsible. In this time of economic stability, when bank profits remain at all-time highs, the United States has an opportunity to take comprehensive action to improve the system.

Reforming the nation's regulatory structure is one of the most significant steps that could be taken to reduce the regulatory burdens on insured depository institutions and help assure their continued success. It would allow banking institutions to compete more effectively and promote better service to consumers. It would create a regulatory structure that is more effective than the current hodgepodge of agencies in overseeing the safety and soundness of individual banking organizations and safeguarding the stability of the banking system as a whole. Regulatory

consolidation would also advance the overall agenda of reinventing government by streamlining the bureaucracy, reducing costs, and improving service. The Department of the Treasury would continue to work with the Federal Reserve and the Congress to develop a final plan that holds true to these principles.

Risks Posed by Over-the-Counter Derivatives

A topic that is receiving a lot of attention from financial markets, regulators, and the global press is the challenges and opportunities posed by over-the-counter derivatives markets. A focus of this section is the U.S. Working Group on Financial Markets, the interagency group originally organized to study the October 1987 stock market break but reinvigorated by former Treasury Secretary Lloyd Bentsen to analyze derivatives issues.[15]

The fast-growing market for swaps and other over-the-counter derivatives has been an innovation of significant value not only to dealers and end users, but also to world economies generally. At the same time, these instruments pose challenges to regulators and financial markets to ensure that their risks are adequately understood and prudently managed.

In an important sense, all the studies, conferences, and hearings on derivatives are welcome. A great deal of useful information has been made available, problems have been identified, and work has been done to solve these problems. However, as useful and productive as all the interest shown in derivatives has been, there is also a danger of overreaction. It is said, for instance, that these instruments are too complex for human understanding. Management is letting the "rocket scientists" in their organizations make heavy bets that put their firms at risk. In different and more difficult market environments, some observers contend, all the derivatives activity that seems so beneficial now will prove to be a curse.

It does not help matters that discussions of the size of this market have focused on notional amounts, and that estimates include numbers as large as S14 trillion. These numbers, of course, are based on different definitions of derivatives and do not say anything about the amount at risk. Short-term and long-term derivatives are equally weighted in these calculations, and nothing is indicated by these numbers about the credit quality of the counterparties or the volatility of the underlying cash markets.

Rather than focusing on the size of this market, participants' use of over-the-counter derivatives products and the effect of this use on their risk profiles must be examined. In other words, while there are legitimate

policy questions, careful analysis is required before reaching the conclusion that there is something going on here that requires a major legislative response.

There are many ways that banks can participate in the derivatives markets. The formulation of guidelines, rules, and examination and supervision procedures has to take into account the risks stemming from the business strategies of the particular banks involved in the derivatives markets. In addition, the bank regulators have to assess the execution of a bank's derivatives business. For example, what techniques are being used to manage risk? What type of management and information systems are in place to monitor and control derivatives activities? What management oversight is there?

Working Group on Financial Markets and Interagency Task Force

As noted above, the U.S. Working Group on Financial Markets was re-established to study the increasing importance of the derivatives market.[16] The working group consists of the Secretary of the Treasury as chairman and the chairs of the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (CFTC). Former Secretary of the Treasury Bentsen designated Frank Newman, then Undersecretary for Domestic Finance, as his representative on the working group.

The working group has been meeting at the principal and senior staff levels on a regular basis since mid-1993. At the same time, an interagency task force of U.S. banking regulators has been considering bank-related derivatives issues.[17] This task force, although not formally part of the working group, in practice has been working closely with the working group's principals and staff on a number of interrelated projects.

Topics that the working group and the interagency task force initially have focused on include accounting and disclosure, netting, regulatory gaps, and legislation. In addition, the working group and the task force have been collecting and sharing data, coordinating views, and educating staff concerning the regulatory activities of each agency.

As the working group continues to examine these issues, its efforts should not be taken to imply that derivatives are a crisis waiting to happen. While derivatives pose certain challenges to the Government in terms of understanding the sometimes complex instruments and strategies employed, it is important to emphasize that derivatives are both a potentially profitable activity for financial institutions acting as dealers and a useful risk-management tool.

Other Risk-Management Measures

If one looks at some of the actions taken by the Government in recent years, one can conclude that it has been trying to remove impediments to this market so that the risk-management and financial innovation potential of derivatives can be realized.

The Futures Trading Practices Act of 1992[18] enabled the CFTC to remove legal uncertainty concerning the applicability of the Commodity Exchange Act[19] to the swaps market.[20] The CFTC promptly used its new exemptive authority to remove the threat that the Commodity Exchange Act might be interpreted to mean that some swaps contracts were illegal and, hence, unenforceable.[21] This was a very positive and helpful step.

In addition, recent amendments to banking laws and the Bankruptcy Code have addressed issues related to the validity of netting and the avoidance of the automatic stay of the Bankruptcy Code with respect to many types of derivatives when certain types of entities become insolvent or file for bankruptcy.[22] The Federal Reserve has adopted a rule, through the authority granted to it under 1991 legislation, to broaden the class of institutions that can benefit from the bilateral and multilateral netting provisions of federal banking laws.[23]

Remaining Issues

Nonetheless, some specific issues do need to be treated. For example, financial statements have become harder to analyze, owing to heavy off-balance-sheet activity. While the bank regulators are working on this issue, accepted accounting practices need to be developed for participants in this market. To this end, the Financial Accounting Standards Board has released new guidelines on disclosure.[24] Furthermore, there is a need for greater transparency in terms of disclosure both to regulators and the public.

Some of the concerns expressed in this area are perhaps more controversial, such as those revolving around the potential difficulty of unwinding positions of a firm that is in liquidation or the systemic risk that these instruments may pose for the financial system. However, based on what is now known, concerns that derivatives could perpetrate a financial meltdown are overblown.

With respect to the liquidity question, it is possible to conceive of a situation, however unlikely, where regulators are constrained in their ability to deal with a failing firm because it has a large and illiquid derivatives book. The liquidity issue is also partly a concern about price transparency. Accurately pricing these complex and custom-tailored products is in some

cases difficult. As the market develops further, these concerns related to liquidity should lessen, but they are issues that need to be considered. Furthermore, dealers who arrange derivatives transactions bear a responsibility to inform end users fully about the nature of these products and the risks that they involve.

It is important to view these issues in perspective. The derivatives market is not just the latest investment innovation from Wall Street, to be guarded against by vigilant regulators. This market can trace some of its roots, for example, to transactions in foreign currency that have been around for a long time. The Government needs to consider, first, what to do to ensure that financial institutions understand what they are doing when they participate in the derivatives markets, and, second, whether there are additional steps that it can usefully take to enable derivatives to meet their potential for enhancing the efficiency of financial markets. While this is not a problem that demands a large dose of additional regulation, this fast-evolving market bears watching, further study, and adoption of a coordinated approach by the existing regulators.

The U.S. Congress continues to take an active interest in derivatives and intermarket issues generally. Several bills have been introduced to address issues affecting U.S. and global derivatives markets.[25] Also, the General Accounting Office released its long-anticipated report to congressional committees on the need for further regulation of this market.[26] In late 1993, the minority staff of the House Banking Committee issued a comprehensive report reviewing industry practices, risks, and regulation.[27] While the Department of the Treasury, the Working Group on Financial Markets, and the interagency task force have not yet developed a position on these legislative proposals, they clearly indicate the importance that U.S. lawmakers attach to these issues.

As this dynamic and influential market moves forward, the challenge is to establish regulatory ground rules that are sufficient to enable the private sector to manage risks prudently but are not so heavy-handed as to stifle innovation and impede the vital contributions that these markets are making to risk management and capital formation. Under the coordinating process that the Department of the Treasury has established, and working closely with the international financial community, the challenge can be met.

Conclusion

There is no shortage of issues for the U.S. Department of the Treasury to deal with in reforming the banking system. However, that department has adopted a careful approach calculated to remove obstacles to the flow

of credit and make the system operate efficiently. It will focus on problems in a deliberate manner and seek achievable goals to prepare the U.S. banking system for the challenges of the next century.

COMMENT

MICHAEL BRADFIELD

Fair Trade in Financial Services

The objective of promoting fair trade in financial services is to remove discrimination against U.S. companies. There is certainly concern that the current Administration has a less-than-complete devotion to that objective. The great objectives of the postwar institutions, to which the International Monetary Fund has significantly contributed, include opening markets for goods and services around the world, eliminating restrictions on current account and capital account transactions, and eliminating discriminatory currency arrangements. The Administration's strong support for the Uruguay Round of negotiations on the General Agreement on Tariffs and Trade and for the North American Free Trade Agreement is a welcome sign of its support for open markets. However, it is not entirely clear that the Fair Trade in Financial Services Act is moving in the same direction.

U.S. policy has been one of national treatment for foreign banks coming into the United States. The Fair Trade in Financial Services Act would replace national treatment with reciprocal national treatment standards.[1] Under the terms of that bill, in order for a foreign bank to get the same treatment that the United States would provide to a bank chartered in the United States, the foreign country where the bank is chartered would have to provide that same treatment to U.S. banks. This policy of reciprocity is certainly not one that has guided the United States up to now. The thrust of the legislation is to give the Government the ability to retaliate against foreign countries if those countries do not give U.S. banks equal competitive access.

This bill is opposed by the Federal Reserve Board. Governor John LaWare stated:

> Free entry and national treatment have served the United States well. And to retreat from these principles, just at a time when the leadership position of the U.S. economy has been reconfirmed, seems to me to be counterintuitive and certainly counterproductive.[2]

One can only hope that the Fair Trade in Financial Services Act, if it passes, will emphasize open markets, not retaliation.

Interstate Branching

In the United States, all of the major objectives of interstate activity in the past have been accomplished through the bank holding company system. In this system, a bank can expand into other states through subsidiary banks in the receiving states, provided that these states have given their consent. In fact, most of the major states, particularly those figuring substantially in the payments system, have already provided for open treatment of banks from other states. Basically, interstate banking has already been accomplished, without the aid of the Riegle-Neal Interstate Banking and Branching Efficiency Act.[3]

However, the argument is made that expanding through branches is much less expensive because a bank will not need to have duplicate administrative tiers in order to accomplish the expansion. If a bank's home state is New York and it has another subsidiary bank in New Jersey, that subsidiary has to have a board of directors and a staff, which allegedly costs money. Actually, it is very simple to operate these institutions with identical boards of directors for all of the banks because there are no residence requirements.

Problems have arisen in the past because of a regional arrangement in the southeastern United States that, in effect, excludes some of the big banks in that area from expanding elsewhere in the United States. The banks in that area want to escape from their own regional arrangement, and the Interstate Banking and Branching Act will allow them to do that. In general, however, it is not a great step forward.

Securities Activities and Other Issues

The absence of some important proposals to change the banking system is somewhat distressing. Legislation to deal with the securities activities of banking organizations is an area that really needs to be addressed, in order to have an effective banking system in the United States. In most countries—but not in the United States—banks can engage in both securities activities and banking activities. The Federal Reserve can use a loophole in the Glass-Steagall Act[4] to authorize what is called a Section 20 company—a company that is not principally engaged in securities activities—to circumvent the rules. However, the Federal Reserve has been very conservative in authorizing banks to engage in these activities. In fact, it has imposed some limitations, decreeing, for instance, that securities activities are impermissible if more than 10 percent of a bank's gross income comes from them. That policy obviously needs to be changed, particularly when the lines dividing the different kinds of activities have

blurred and banking activities have become financial activities, which, in turn, have moved into the area of investment banking activities and securities activities. It does not make much sense today to say that banks can be engaged only in banking and lending, when their direct competitors can participate in activities, such as the securitization of financial claims, from which banks are excluded.

Another area where the U.S. banking system probably needs change is in the Federal Deposit Insurance Corporation Improvement Act, which was adopted in December 1991.[5] This law, which imposes heavy regulatory burdens on banks, was a reaction by Congress to the enormous losses in the savings and loan industry, as well as to the failures of substantial numbers of small banks, particularly in Texas and New England. In response, Congress enacted this draconian legislation, which was designed to detect at very early stages problems in financial or banking institutions and to require mandatory actions by the regulators. Instead of giving them flexibility in deciding how to respond to these problems, the Federal Deposit Insurance Corporation Improvement Act insisted that the regulators take specific, increasingly severe steps to correct these matters. The law also imposed very substantial reporting burdens. Admittedly, there were certain things that needed to be corrected; however, they were probably overcorrected. Therefore, the legislation needs to be looked at again with a view to eliminating duplicative requirements imposed on banks.

Regulatory Consolidation

The U.S. Department of the Treasury's proposal to consolidate regulatory responsibilities would take the responsibilities of the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve and combine them with those of the Office of Thrift Supervision to create a new federal banking agency, the Federal Banking Commission.[6] Various provisions are made to give the Federal Reserve, in a sense, a seat at the table. The Federal Reserve would be able to participate in some examinations of banks, in order to give it a hands-on role in regulating the banking system. However, the Federal Reserve's basic authority over state member banks and bank holding companies would be removed.

The benefits of this proposal are said to be the elimination of conflicts of interest, improved supervision, elimination of inconsistent regulations, increased accountability, and reduction in costs. A case can be made, however, that these arguments do not have much merit.

The Current Regulatory System

The first rule that should be followed in any regulatory reorganization is "do no harm." About the existing system, Winston Churchill's description of democracy is relevant. He said that it is "the worst system that has ever been invented by man, except for any other." In a sense, that can be said about the present regulatory system in the United States, with its regulators and various centers of authority. The Federal Reserve regulates member banks and bank holding companies. The FDIC is in charge of the deposit insurance system and regulates state nonmember banks. The Office of the Comptroller of the Currency charters and regulates national banks. The states charter banks and function as primary regulators of all state banks. They participate, together with the Federal Reserve and the FDIC, in regulating those banks, depending on whether they are members of the Federal Reserve System.

The current regulatory system serves some very important interests. It gives the Department of the Treasury a direct input into the financial system, particularly the banking system, as the Office of the Comptroller of the Currency reports directly to the Secretary of the Treasury. It is important that the Treasury have that kind of presence in a system designed to supervise and regulate banks. Similarly, the Federal Reserve believes that its ability to carry out its central banking functions depends importantly on its participation in the regulation of banks, in particular bank holding companies. If that role were to be taken away, the prestige and authority of the Federal Reserve would be substantially diminished.

No banking system in the world has the dispersion of economic power that has been deliberately encouraged in the U.S. system. First, it should be emphasised that there are over 11,000 commercial banks in the United States. In most systems around the world, although there may be a significant number of financial institutions, including banking institutions, the number of commercial banks is nowhere near this large. Second, in other countries, a few commercial banks usually hold 90–95 percent of the commercial banking assets. In the United States, between 80 and 100 banks have 80–85 percent of the commercial banking assets. So, in the United States, where power is deconcentrated in a widely dispersed system, there has been a tradition of resistance to concentrating power in large banking institutions. In this kind of system, it is understandable that there would be a multiplicity of regulators and power centers. The present regulatory system genuinely reflects these interests; one cannot simply do away with it—and the representation of certain critical parties—and not expect problems to develop. Taking the Federal Reserve's authority away would upset a delicately balanced system that has worked reasonably well.

Moreover, the failures in the banking and thrift system should not be blamed on inadequacies in the regulatory system. First, the failures were not unique to the United States. Many other banking systems had similar problems. In particular, there seemed to be a worldwide epidemic of overinvestment in, and overlending to, the real estate sector. When the markets collapsed, banks and banking systems collapsed, requiring central bank support. Today, the banking system is in much better shape. In the United States, there has been a major recovery, as capital ratios have been restored. Credit for this improvement could go to the existing regulatory system.

The Administration's Proposal

Meanwhile, the Administration's proposal substitutes one admittedly complicated system, which can be said to have worked reasonably well, for another complicated system, which may or may not work reasonably well. It is questionable whether, in disenfranchising elements of the current system, the new system would work as well. (In particular, the states and the Federal Reserve feel that they would be disenfranchised.)

What really occured in the 1980s was a failure of ideology. There was a very strong deregulatory push, and depository institutions, particularly savings and loans, were encouraged to engage in new kinds of financial activities. However, these institutions did not have the experience to engage in these activities, and the Government was unwilling to provide the resources needed for adequate supervision.

The Federal Reserve in this situation took an entirely different view. It was very reluctant to support deregulation. A former Chairman of the Federal Reserve Board used to say, when legislation to authorize savings and loans to engage in commercial lending was being discussed in Congress, that if the savings and loans were given the authority to make commercial loans they would end up with all of the bad commercial loans. They did. The situation would not be made better if the Administration's proposal were adopted; it could be made worse. If there were but a single agency, and if it had a wrongheaded idea about the financial system and how it ought to be operated, there could be a very serious, perhaps even uncontrollable problem.

One point that is made by supporters of the Administration's proposal is that there is a conflict of interest between the central bank's role as the agency responsible for monetary policy and its supervisory role. The two objectives will conflict. In order to play the role of supervisor, the central bank will be encouraged to ameliorate or modify monetary policy in a way that it should not. One may ask the question, Is it not essen-

tial that when the need arises the objectives (the monetary policy objective and the supervisory policy) at stake be weighed against each other properly?

Rather than a conflict, a judgment is needed. The institution best capable of making that judgment is the monetary authority itself. It can decide whether its monetary goals will be compromised or whether the system will be compromised by allowing the individual bank to fail.

Marinner Eccles, a Chairman of the Federal Reserve in the 1930s, wanted to encourage economic growth during the depression of the 1930s. He called for all regulatory authority to be concentrated in the Federal Reserve because he was concerned that the FDIC was too conservative and was frustrating monetary policy by discouraging banks from lending, rather than expanding lending to business and moving the country out of the depression.

When the current Administration was concerned about a credit crunch, it sought support from the Federal Reserve Board in encouraging banks to lend. The Federal Reserve responded, as did the other regulatory agencies. However, the Federal Reserve was probably in a better position to respond effectively in that situation, in view of its knowledge of developments in the system and its participation in the regulatory and supervisory activities.

Another argument for consolidation focuses on its supposed major benefit—the reduction in expenses that it would generate. This argument is particularly weak, because the amount of the reduction that was cited should obviously be of concern to the banking industry. Yet the banking industry does not have any interest in this legislation, even though it would not miss an opportunity to reduce its cost if it really thought that consolidation could achieve that end. If the industry is not interested in consolidation, or does not believe that it is going to result in this cost reduction, to the argumentation underlying the proposal is weakened considerably.

Another argument for consolidation is better supervision. Looking at the problems in the U.S. banking system in the 1980s and early 1990s, 73 percent of the net losses in the banking system (that is, the losses experienced by the FDIC net of the insurance contributions of those institutions) were losses of OCC-supervised banks. Thirty-five percent were losses of institutions supervised by the FDIC. For the Federal Reserve-supervised institutions, there was a net gain of $1 billion, according to a House Banking Committee study. Logic would thus seem to point in the opposite direction of the position taken by the supporters of the consolidation proposal. To have better supervision, all of the regulatory author-

ity should be placed in the Federal Reserve. This thinking may not, however, govern the situation.

The heart of the problem is: Will the Administration proposal affect the independence and the ability of the Federal Reserve to carry out monetary policy? Supporters of the proposal say there will not be any problem at all. However, regulating bank holding companies is critical to the Federal Reserve's ability to carry out all of its functions. It gives the Federal Reserve a presence and a power in the banking system that cannot be ignored. If the system is changed, banks may more often ignore a Federal Reserve Governor or the Federal Reserve Board.

Three reasons for maintaining this close linkage of monetary policy authority and supervision have been adduced. First, liquidity problems in particular institutions are the first sign of insolvency; therefore, the central bank needs to know about these problems immediately. The ability to prevent liquidity and insolvency problems from spreading once the supervisor learns about them is a critical function of the central banks. Strong linkage between the functions of overseeing the soundness of the banking system and preventing systemic risks is essential.

Second, if the Federal Reserve's authority were taken away, its ability to maintain staffing would become a concern. The Federal Reserve has a highly qualified staff. If its authority were limited to looking over institutions that were subject to the primary jurisdiction of the Federal Banking Commission in the regulation and supervision of banks, it is doubtful whether the current high quality and integrity of the Federal Reserve's staff could be maintained. This outcome would seriously affect the ability of the Federal Reserve to carry out its monetary policy functions.

Third, price stability has become, all over the world, a major objective of economic policy. Inflation, of course, is a monetary phenomenon, and central banks play the most important role in guarding against it. Therefore, the tendency almost everywhere has been to give central banks more freedom from political interference. At the same time, there seems to be much more concern about systemic risk. The development of derivatives, the integration of the financial systems, and the vast amounts of money that move across exchanges in a single day have all exacerbated this concern and emphasized the need for central bank independence. France has recently adopted legislation to make its central bank independent,[7] as have Argentina and Mexico.[8] In France, as in the United States, there was a battle over the question of whether the central bank would maintain authority for bank supervision.[9]

Paul Volcker, former Chairman of the Federal Reserve Board, in a speech before the Bank of Italy on the celebration of its hundredth

anniversary, talked about these very issues. Addressing the complexity of the problems facing central banks, both in terms of monetary policy and systemic risk, he said:

> How ironic it is that right now, just when so much is at stake, some would weaken the capacity of central banks to deal with the pressing concerns and to shape the direction of change. Central banks alone have neither the authority nor capacity to regulate and supervise the whole field of finance; but their concerns, their experience, and their capacity to work together surely should be brought effectively to bear.

The message is that, rather than weaken the central bank, the central bank should be strengthened in the United States and elsewhere. For these reasons, it is unlikely that the Administration's consolidation proposal will be accepted in the United States.

Derivatives

These new instruments respond to an inability of banks to offer other risk-shifting products, particularly in the United States, where these products originated. Swaps, options, and other such instruments were initiated, in a sense, as alternatives to the risk shifting provided by securitization. There is now widespread use of derivatives. Innovation has apparently created at least the potential for serious systemic risk. This story has been heard before, whether in the context of lending to less developed countries or lending to the real estate and oil sectors. There is a tendency for lending to become overconcentrated.

What characterizes the derivatives business, however, is the sophisticated nature of the players and their ability to bear risk. So far, it appears that they can analyze the risks and bear them effectively. The economic outlook has changed very substantially, in particular with respect to interest rates, which has, in turn, substantially changed the values of various economic instruments without causing any systemic problems.

There is a problem with derivatives, and there is a tendency to regulate. However, one of the problems that arises from this tendency is that it then leads to a tendency to regulate banks and not their nonbank competitors. In the United States, at least, proposals have been made to enact legislation to attack this problem on an across-the-board basis by regulating not only banks but also commodities and securities firms as players in this market.

Another related concern derives from the extent to which the United States might choose to regulate the derivatives activity of banks or other financial firms. If it chose to do so extensively, the market would be more

likely to move overseas to other countries without such regulation. Banks must be allowed to participate in these markets in a manner that enables them to compete with their nonregulated colleagues without invoking the deposit insurance or lender-of-last-resort functions.

Conclusion

There are number of important issues involving the U.S. financial system that need to be addressed by U.S. regulators. The adoption of the Riegle-Neal Interstate Banking and Branching Efficiency Act[10] is a signal that they are moving in the right direction. In other areas, such as fair trade in financial services and consolidation, real problems continue to exist.

Chapter

13 Banking Law Developments in the United Kingdom

WILLIAM BLAIR

Introduction

This chapter reviews some of the more important recent developments in U.K. banking law. The term "U.K. banking law" needs some explanation. It covers a wide range of legal territory that affects banks and their businesses. There is a U.K. Banking Act,[1] but it is primarily concerned with the regulation of deposit taking by the central bank, that is, the Bank of England. There are, of course, many other statutes that impinge on banking business, although there is no "commercial banking law" of the type found in some countries, which circumscribes the business that commercial banks may carry on. In the tradition of the common law, much of the English law of banking is judge made. Finally, although many statutes apply to the whole country, the Scottish system in particular differs from that of England, both in ethos and in derivation.

In the past decade or so, undoubtedly the most pronounced development in U.K. banking law has been the growth in the formal body of regulatory law. It is curious to reflect that this growth has taken place at a time when "deregulation" has been the avowed political objective, but such is the fact. Deregulation has, of course, had its part to play, particularly in breaking down the barriers between different parts of the financial sector. Two separate though interlocked regimes regulate banking and investment business. In the case of the latter, a major and as yet unresolved challenge is to achieve a satisfactory balance between a regulatory system that gives due investor protection without placing an unnecessary burden on business.

The second major development—and undoubtedly this will be the most significant in the long term—has been the slow integration of the European financial sector. A single currency may still be a long way off, but the legal framework in which banking business is regulated is converging in many other respects. The most spectacular example of this is the "single passport" provision that came into effect throughout the European Union on January 1, 1993. In the field of private law, also, Europeanization has been proceeding apace. The common law is proving

well able to adapt, and lawyers in England and mainland Europe are fruitfully learning each other's strengths.

The third development is perhaps more difficult to quantify precisely, but, in a number of respects, there is a growing recognition of what might be termed the "social dimension" of banking. Banks play such an important role in society that inevitably higher standards come to be expected of them than of some other commercial businesses. Some examples are mentioned in this chapter. New rules on money laundering are placing active responsibilities on banks throughout Europe to prevent the abuse of the banking system. On the level of their day-to-day business, U.K. banks have responded to consumer pressure by introducing the Code of Banking Practice, by which they voluntarily undertake to follow principles of best practice in their dealings with customers.

These are the major themes on which this chapter will concentrate. There are, of course, many other developments of note across such a wide field. A recurring problem is one of achieving a balance between the new (and sometimes onerous) demands on banks and the commercial imperatives of a healthy and profitable industry.

Changes in the Structure of Regulation

Banking Business

As already indicated, English law does not have an overall definition of banking business. Historically, clear distinctions have been made between the types of business that various parts of the banking sector carry on, particularly between the "clearing" banks carrying on deposit taking and lending, and the "merchant" banks carrying on investment banking and securities business. At the retail level, "building societies" (roughly equivalent to U.S. thrifts) play a central role in absorbing savings and re-lending them as home loans. Also, international banking has enjoyed a solid revival in London in the past few years; as of 1993, 527 foreign institutions were represented in the United Kingdom.[2]

The Bank of England has long played a pivotal role in the regulation and orderly development of the U.K. banking sector. It has often been remarked that, until recently, it did so with very few formal statutory powers. When the Bank was nationalized in 1946, the Bank of England Act gave it power[3] to issue directions to bankers, but this power was never exercised. The first formal legislation of real substance was the Banking Act, 1979,[4] which required institutions carrying on deposit-taking business within the United Kingdom to obtain authorization from

the Bank of England. The current statute is the Banking Act, 1987,[5] which gave the Bank significant new powers, although both the Bank and the Government expressed the view that the changes were not designed to make a fundamental break with the past.[6] This sense of continuity and informality remains an important and valuable feature of the conduct of banking supervision by the Bank of England.

Banking Act, 1987, contains a variety of provisions and powers. The acceptance of deposits within the United Kingdom without authorization is prohibited, and the minimum criteria for authorization are specified. There are powers to regulate the ownership of U.K.-incorporated banks by objecting to new or increased control over them. Specific provisions regulate advertisements for deposits, large exposures, accounts and auditors, investigations, banking names, and descriptions; also, ancillary powers are specified, such as the right to apply to the courts for winding-up orders and injunctions.

Part 2 of the Banking Act is concerned with the Deposit Protection Scheme. The scheme remains (by U.S. standards) relatively conservative: in the event of an authorized institution's insolvency, the Deposit Protection Board pays each depositor up to 75 percent of the first £20,000 of a sterling deposit with a U.K. office of the institution.[7]

The system of prudential supervision depends heavily on the provision of regular returns to the Bank of England. Traditionally, this information has been supplied voluntarily. It was said at the time that the statutory provisions in the Banking Act, 1987, empowering the Bank to compel the provision of information, were enacted to cover the possibility that institutions not used to the customary style of supervision might be backward in supplying what was needed.[8] Section 39 gives the Bank wide powers to require the provision of information from, and the production of documents by, an authorized institution and its parents or subsidiaries.

The principal prudential reporting tool is the Capital Adequacy Return (Form BSD1), which has to be completed quarterly by U.K.-incorporated institutions authorized under the Banking Act. The Bank issues detailed guidance notes dealing with the completion of this form. Separate returns deal with such matters as the analysis of large exposures.[9]

The other main components of regulatory law are as follows. A number of statutory instruments (for example, those dealing with deposit advertisements) have been issued under the Banking Act. In practice, "notices" issued by the Bank are equally important and cover a much wider scope. These notices deal with issues relating to supervision, monetary control, and other matters, and they have been used to implement European Community (EC) directives. They do not have force of law as

such, but are in practice treated as binding by the institutions subject to the Bank of England's supervisory control.

Investment Business

The boundary between banking business and investment business is often blurred, particularly in the United Kingdom, where there has never been an equivalent of the U.S. Glass-Steagall Act of 1933,[10] which enforced the separation of banking and securities businesses. The realignment of the financial sector was accelerated by London's so-called Big Bang of the mid-1980s, the effect of which was the acquisition of a large number of market-making and stockbroking firms by British and non-British banks to form financial conglomerates.

The general continuity of approach that has marked the supervision of banking business through the agency of the Bank of England has not applied to the supervision of investment business. "Investment business" is statutorily defined to include such activities as shares dealing, debt securities, government and public securities, warrants, certificates representing securities, options, futures and long-term insurance contracts, and the giving of investment advice.[11]

Until 1986, the formal statutory regulation of investment business was comparatively light.[12] The Financial Services Act, 1986,[13] was an attempt to provide a cohesive system of regulation. Two often competing factors were at work in the conception of this system. First, political pressure was generated by the general recognition of insufficiently high standards of investor protection (particularly at the retail level), and of the need for a greater degree of public protection than was currently available. Second, the industry had a strong desire to avoid what was perceived to be the overly formal U.S. regulatory rules and the overly powerful Securities and Exchange Commission. The system that these factors produced was described as one of "self-regulation." It is debatable how far it has been a success.

In terms of structure, the Securities and Investments Board is the umbrella body. It presides over a number of self-regulating trade organizations. The theory is that authorization to conduct investment business within the United Kingdom is primarily obtained by joining such an organization. The Securities and Investments Board requires the self-regulating trade organizations to have in force rules to maintain proper standards of business conduct and capital adequacy levels among their members.

The system is undergoing a continuing process of adaptation. Two points in particular may be noted. There has been a welcome move away from too-detailed rule books to more general statements of principle and

core business conduct rules. It has been belatedly recognized that the emphasis on self-regulation by the industry has tended to neglect the interests of the small investor—the very person who needs protection most. To meet this concern, a new self-regulated trade organization, the Personal Investment Authority, is being set up as a unified organization with particular responsibility for the retail sector.

In summary, the body of U.K. law regulating investment business is primarily to be found in the Financial Services Act, 1986, statutory instruments made under that act, various EC directives, and the rules and regulations issued by the Securities and Investments Board and the self-regulating trade organizations pursuant to their statutory powers.

Bank of England's Role in Regulating Investment Business

As has been mentioned, the regulation of banking and investment business is separate, but it does interlock. This is well illustrated by the role of the Bank of England, which, in practice, figures importantly in the regulation of both investment and banking business. Thus the wholesale London money markets are exempted from the scope of the Financial Services Act altogether[14] and remain subject to nonstatutory supervision by the Bank of England. These markets primarily comprise the short-term markets in sterling, foreign currency, and bullion. The Bank of England issues the London Code of Conduct, which sets out the principles that should govern the conduct of those transacting business in the markets to ensure that the highest standards of integrity and fair dealing are observed.[15]

Where a bank carries on investment business, prudential supervision remains a matter for the Bank of England under the "lead regulation principle." This principle is designed to avoid wasteful duplication in the financial supervision of institutions. In the case of financial conglomerates comprising banking and other businesses, prudential supervision is coordinated by an informal, nonstatutory body called the College of Supervisors, which is chaired by the Bank of England.

In the aftermath of the regulatory upheavals of the past decade, the Bank of England remains pre-eminent in the regulation of the City of London and the U.K. financial system as a whole; if anything, moreover, the trend is toward the consolidation of its position.

The Integration of the European Financial Sector and the Single Passport Provisions

The emergence of the European Union[16] has been a remarkable achievement. Although the United Kingdom has often adopted a con-

servative approach to federal tendencies, it should perhaps be stressed that it has an excellent record for implementing EC directives, once agreed. In the field of banking regulation, European developments have been increasingly important and have proceeded along two distinct lines. First, Council directives have sought to standardize regulatory rules on a number of key aspects, such as own funds,[17] solvency ratios (mirroring the 1988 Basle Capital Accord),[18] consolidated supervision,[19] large exposures,[20] and deposit guarantee schemes.[21] The EC Directive on Deposit Guarantee Schemes[22] requires all EC member states to operate a deposit protection scheme covering all depositors in European banks for which they have home state supervisory responsibility and sets minimum standards as to the protection provided.

Second, since January 1, 1993, a credit institution[23] authorized in one member state may under the provisions of the Second Banking Directive[24] carry on the banking activities that it is authorized to carry on within that state throughout the EC without the need for further authorization. The activities covered are those set out in the annex to the Second Banking Directive.[25]

The Second Banking Directive has been implemented in the United Kingdom by the Banking Coordination (Second Council Directive) Regulations, 1992.[26] The result of this landmark reform is that the Bank of England no longer authorizes banks incorporated in other member states with ***branches*** in the United Kingdom. These branches may now accept deposits in the United Kingdom without the Bank's authorization: the authorization of their home state supervisor is sufficient, provided that certain notification requirements are met. U.K.-incorporated ***subsidiaries*** of banks incorporated in other member states wishing to accept deposits in the United Kingdom do, however, continue to require authorization by the Bank, as previously.

The activities listed in the annex to the Second Banking Directive include activities that constitute investment business under the provisions of the Financial Services Act, 1986. As a result of the directive, however, if a bank is authorized to carry on such activities in its home state, it will no longer require separate authorization in the United Kingdom under the Financial Services Act.

The Bank of England has limited responsibilities and powers in respect of European institutions. Its principal responsibilities lie in liquidating the institutions' branches in the United Kingdom and in assisting the home state supervisory authorities in supervising the institutions' exposures to market risks in the United Kingdom.

The Bank of England does retain certain powers to impose prohibitions on, or restrict the listed activities of, European institutions in the United Kingdom. The Bank has stated that

> consistent with the allocation of supervisory responsibility in the Directive, the Bank will usually only exercise its powers after consulting the home State authority and, indeed, in certain circumstances the Regulations explicitly require the Bank to do this. In most cases, the home State authority will be best placed to take action to ensure that the institution rectifies a situation which might otherwise provide grounds for the Bank to exercise its powers.[27]

To assist the home state authority, and to be better able to determine whether its powers are exercisable and should be exercised, the Bank of England has signed memorandums of understanding with a number of EC authorities (and is currently in the process of agreeing memorandums with the remaining authorities). The memorandums deal with such matters as the exchange of information in crisis situations and when the authorities become aware of contraventions of the law.[28]

Such a prohibition or restriction may be imposed when, for example, the branch of a European institution has not maintained adequate liquidity, has failed to comply with the applicable law, or has provided misleading information, and when the Bank of England has been notified of various similar failures by a supervisory authority in the institution's home state.

The practical result of these provisions is that, where a bank is operating throughout Europe on the basis of a single authorization, regulatory action against it will have to be taken on a coordinated basis, with the home state regulatory authority taking primary responsibility for the action.

The principles contained in the eighth recital to the Second Banking Directive[29] seek to address the possibility of abuse of the single passport provisions. First, member states should take steps to prevent supervisory forum-shopping. Second, an institution's place of incorporation (and thus its registered office) should be treated as its home. Third, an institution's head office should be in the same member state as its registered office. Thus an institution should not be permitted to incorporate and subject itself to supervision in a member state where it judges supervisory standards to be most lax while effectively running its business from another member state where supervisory standards are thought to be more rigorous.

An equivalent Investment Services Directive[30] was adopted on May 10, 1993, to be implemented by December 31, 1995.[31] The business activi-

ties covered by the single passport provisions of the directive are contained in an annex to it.[32]

Developments Affecting Regulatory Law

The matters discussed above concern the structure of regulatory law. Also, a number of noteworthy developments of a more specific nature will affect the regulation of banks to a greater or lesser degree. Five of these are now considered.

Duties of Auditors

The affair involving the Bank of Credit and Commerce International (BCCI) threw into sharp focus the role of auditors in the regulatory process. Auditors are, of course, engaged by the company that they are auditing, which is responsible for paying their fees. The relationship between auditor and company can be a sensitive one, in part because bank auditors are often better placed than the supervising authority to detect regulatory breaches at an early stage.

Under English law, auditors were until very recently ***permitted*** to communicate with the Bank of England as regulatory authority without breaching their duty of confidentiality to their clients; however, they were not ***obliged*** to do so. Under the auditing guidelines of the Institute of Chartered Accountants, auditors and reporting accountants were, however, subject to a clear professional duty to report directly to the Bank in the circumstances specified in the guidelines. In his Inquiry into the Supervision of the Bank of Credit and Commerce International,[33] Lord Justice Bingham recommended that a legal duty to report should be imposed, principally on the ground that this would strengthen the position of the auditors and clarify the content of their duties in law.[34]

That recommendation has been adopted. As from May 1, 1994, the Accountants (Banking Act 1987) Regulations, 1994,[35] specify that auditors or reporting accountants are to communicate to the Bank of England material matters that give them reasonable cause to believe that the bank in question no longer fulfills the minimum criteria for authorization. In summary, these criteria are that

- directors, controllers, and managers are fit and proper to hold their particular positions;
- at least two individuals effectively direct the business;
- there is an appropriate number of non-executive directors for home-incorporated institutions;

- the business is conducted in a prudent manner and maintains net assets or own funds of appropriate amounts;
- the business maintains adequate liquidity and has adequate accounting and other records;
- the business is carried on with integrity and professional skill; and
- the business holds minimum net assets of the specified amount.

Similar provisions apply to building society auditors and auditors of investment businesses authorized under the Financial Services Act.[36]

Derivatives and Legal Risk

The term "derivatives" covers a wide range of instruments of varying degrees of complexity. There has been considerable recent controversy over the regulatory aspects of these instruments, in particular their potential effect on a bank's financial soundness. It may safely be predicted that the controversy is far from over. In this section, a different aspect of derivatives is considered, namely, the legal risk factor.

Financial markets depend on the confidence that obligations will be honored, and derivatives markets have a good record in this respect. However, all such instruments are, in essence, a contract or series of contracts that depend for their ultimate efficacy on the effectiveness of the contractual relationships in law.

The legal risks that derivatives are capable of creating were exemplified by the famous (or infamous) 1991 swaps litigation, which was finally resolved by the House of Lords, the supreme court for the United Kingdom. The instruments in question were interest rate swaps, and the counterparties were U.K. local authorities. In its simplest form, an interest rate swap is an agreement by which one party agrees to pay a fixed rate of interest by reference to a notional capital sum, and by which the other party agrees to pay a floating rate, such as the London interbank offered rate. In practice, the contracts are settled periodically on a net basis.

In the mid-1980s, many such contracts were entered into by a number of U.K. local authorities for purely speculative purposes. Their legal power to do so was challenged by the Audit Commission, a public body charged with auditing local authority spending. The House of Lords held[37] that the authorities had no *express* power under the Local Government Act, 1972,[38] to enter into swaps transactions, and that it could not be said that such transactions were *incidental* to their borrowing powers. The transactions were, therefore, *ultra vires* and void.

The decision prompted a good deal of concern on the London markets and led indirectly to the setting up of the Financial Law Panel under the aegis of the Bank of England. The panel is a small body of City practitioners who undertake to keep financial law under review, alerting fellow practitioners as to emerging risks and recommending best practice. It is important to note that the House of Lords' decision itself was of limited effect. The swaps transactions were invalidated because of the particular nature of the counterparties, which were local authorities set up by statute and with powers beyond those given by statute. In other words, the issue was one of the legal capacity of the parties, not the enforceability of the underlying contractual obligations.

The House of Lords' ruling left a large number of transactions to be unwound. The English courts have subsequently held that payments made under void swaps contracts are recoverable; the local authorities have thus been obliged to return payments made to them (with compound interest), and vice versa.[39]

The Scottish courts have followed the English courts in holding that swaps contracts are *ultra vires* local authorities under the relevant Scottish legislation[40] and therefore void. The Scottish courts, however, have also held that payments made under such agreements are not recoverable, applying the doctrine that payments made under a mistake of law generally cannot be recovered.[41] It remains to be seen whether the different results achieved under English and Scottish law will be resolved by the House of Lords.

Setoff

Setoff is the legal principle by which claims owing between the same parties are set off against each other, so that only a net amount is payable. It is particularly important in the banking field, where obligations are invariably monetary in character. The law of setoff will determine, for example, the amount owing on the insolvency of a customer or on the insolvency of the bank itself. As a leading lawyer puts it: "Set-off plays a crucial role in international financial and commercial affairs. This is because of its security function. Claims are a major form of property and the reciprocity of claims produces a field of law comparable to that of security proper."[42]

The basic English law rules of setoff are well settled. The banker's right of setoff—a bank's right in the absence of contrary agreement to set its customer's accounts off against each other—is long established.[43] The fundamental principle is that, to qualify for setoff, debts must be between the same parties in the same right and must all have matured. With insol-

vency, setoff is mandatory, so that only the balance can be claimed by the liquidator or proved for in the liquidation.[44]

The operation of netting procedures on the financial markets has recently been buttressed by statute. It has been enacted that the proceedings of a recognized investment exchange or clearinghouse (for example, its default and settlement rules) are to take precedence over insolvency law.[45] Also, the courts have held that in case law the guarantors of obligations of former customers of BCCI are entitled to set off the amount of deposits held as security,[46] but the result has varied according to the nature of the security documentation.[47]

Cash collateral arrangements also involve setoff considerations. There are a number of situations in which a bank may stipulate for a specific deposit against a specific liability, for example, when issuing a performance guarantee at a customer's request. In these circumstances, security over the deposit is required. Security documentation is taken in the form of a contractual setoff right, an agreement by the customer that the deposit is not to be repayable until the relevant obligations are repaid to the bank, or a charge over the deposit (or a combination of all three). A good deal of controversy has been generated by the question of whether a bank can, strictly speaking, take a charge over a deposit held with itself (as opposed to a deposit held with another bank). It has been argued that there are conceptual difficulties in a debtor (that is, the bank holding the deposit) taking a charge over its own indebtedness to the depositor.[48] Recent authority, however, has tended to indicate that such a charge is possible,[49] and it is to be hoped that this view prevails. In any event, the debate is to a considerable extent academic; a bank's setoff rights are usually sufficient to protect its position.

In the regulatory field, the law of setoff has an important impact on on-balance-sheet netting and cash collateral arrangements for capital adequacy purposes. As from 1994, the Bank of England has tightened the reporting requirements in this respect. In the case of on-balance-sheet netting, accounts with the reporting bank may be offset against credit balances on other accounts only if a legal opinion has been obtained to the effect that a legal right of setoff exists, and if the bank's right to apply setoff is legally well-founded in all relevant jurisdictions and would be enforceable in the default or insolvency of the customer or the bank itself. For a group facility, the arrangement must be supported by a full cross-guarantee structure. The debit and credit balances must relate to the same customer or to customers in the same group, and the netted accounts must be managed and controlled on a net basis.

If exposures that do not meet the rules for setoff are collateralized by cash, they are reported under the relevant item in the zero percent band.

An exposure is collateralized by cash for these purposes only if the cash is held on the terms that it may not be withdrawn for the duration of the exposure, and that the reporting institution may apply the cash to discharge the exposure on default. Again, the Bank has specified that the reporting institution must obtain a legal opinion to the effect that the collateral arrangements are legally well-founded.[50]

Money Laundering

International cooperation implemented by national legislation against money laundering is perceived as one of the principal weapons in the fight against illegal drug trafficking. The United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances of 1988[51] requires Parties to legislate as necessary to establish a modern code of criminal offenses relating to illicit trafficking in all its different aspects. Pursuant to Article 3(1)(b), parties are required to treat money laundering as a criminal offense. Many countries have done so, although few have gone as far as the United States, which requires cash transactions of over $10,000 to be reported under the provisions of the Bank Secrecy Act.[52] As far as the United Kingdom is concerned, the most recent development has been the implementation of the EC's Money-Laundering Directive.[53] Rather than impose a blanket reporting obligation, the directive is intended to place the onus on financial institutions to identify customers who deal with them and to report transactions that are suspicious.

The Money-Laundering Directive is not limited to drug-trafficking offenses; it extends to other forms of criminal activity. The effect of these changes will take some time to work through, but they appear to involve a fundamental reappraisal of the banker's traditional role. Not only are rules of banking secrecy overridden, but banks are expected to take an active part in preventing abuse of the financial system. In applying the new rules, it is hoped that the courts will seek to achieve a balance between requiring banks to take reasonable steps to thwart obviously tainted transactions and requiring banks to act as detectives, a role for which they are not suited.

Central banks have played an important part in promoting anti-money-laundering measures. As the Basle Committee on Banking Regulations and Supervisory Practices put it in 1988, although the primary function of banking supervision "is to maintain the overall financial stability and soundness of banks rather than to ensure that individual transactions conducted by bank customers are legitimate . . . all members of the Committee firmly believe that supervisors cannot be indifferent to the use made of banks by criminals."[54]

The Bank of England wrote to banks on November 10, 1989, reminding them of the provisions of the Basle Statement of Principles. The statement remains an important summary of the basic steps expected of banks, namely, to

- know their customers;
- comply with all relevant laws;
- cooperate with law enforcement agencies; and
- adhere to the following statement:

> All banks should formally adopt policies consistent with the principles set out in this Statement and should ensure that all members of their staff concerned, wherever located, are informed of the bank's policy in this regard. Attention should be given to staff training in matters covered by the Statement. To promote adherence to these principles banks should implement specific procedures for customer identification and for retaining internal records of transactions. Arrangements for internal audit may need to be extended in order to establish an effective means of testing for general compliance with the Statement.[55]

The already substantial body of U.K. law relating to money laundering[56] was extended substantially to cover the proceeds of all serious crime, in addition to drug- and terrorist-related activities, by the Criminal Justice Act, 1993,[57] and the Money-Laundering Regulations, 1993,[58] which contain the provisions necessary to implement the EC Money-Laundering Directive. Under the Act, it is a criminal offense for a person who knows or suspects that another person is engaged in the laundering of drug money to fail to disclose the fact to the police.[59] "Tipping off" the subject of an investigation into the laundering of drug money also becomes a criminal offense.

The Money-Laundering Regulations came into force on April 1, 1994. They apply (among others) to banks, building societies, and investment businesses. The regulations require the establishment of (i) identification procedures (to identify the person with whom business is being transacted), (ii) record-keeping procedures, (iii) internal reporting procedures, and (iv) "such other procedures of internal control and communication as may be appropriate for the purposes of forestalling and preventing money-laundering."[60] Failure to comply with the regulations is a criminal offense. There are exemptions for transactions of small monetary value.[61]

Independent duties are also placed upon certain supervisory authorities, including the Bank of England. Supervisors are placed under an obli-

gation to disclose information indicative of money laundering to the police.[62]

In addition to these often complicated (and sometimes obscure) statutory provisions, "guidance notes" have been issued to provide a practical interpretation of the regulations and give examples of good practice. The guidance notes are produced by the Joint Money-Laundering Steering Group, which includes representatives of the Bank of England, the British Bankers' Association, building societies, banks, investment businesses, and the National Criminal Intelligence Services. There are three sets of guidance notes. The first covers all mainstream banking, lending, and deposit-taking activities of banks and building societies within the jurisdiction of the United Kingdom, including the taking of sterling and foreign currency wholesale deposits. The second covers insurance and retail investment products, and the third covers wholesale institutional and private client investment business.

The guidance notes for all three sets are couched in similar terms. They offer practical guidance in relation to such matters as identification procedures and record keeping. Although they are not mandatory and have no legal effect, it is noteworthy that the Bank of England indicates in its statement of the minimum criteria of authorization applicable under the Banking Act that the requirement for carrying on the business of a bank with integrity and skill is unlikely to be satisfied if an institution fails to comply with the guidance notes on money laundering.[63]

These provisions represent, of course, a major inroad into the traditional rule that a bank must respect the confidentiality of its customers' affairs. In English law, this rule is judge made,[64] but it has always been subject to qualifications. It does not follow, however, that the confidentiality rule is in any sense redundant. In the normal course, customers are entitled to expect that banks will keep their affairs secret. The money-laundering provisions are justified as an exception made in the wider public interest.

Environmental Liability[65]

No discussion of recent developments in banking law is complete without a mention of the intense debate as to the circumstances, if any, in which a bank as lender may incur liability under new or proposed environmental production legislation for the polluting activity of its borrowers. In Europe, comparisons have been drawn with the position in the United States, where the Comprehensive Environmental Response Compensation and Liability Act of 1980,[66] as amended in 1986 by the Superfund Amendments and Reauthorization Act of 1986,[67] permits the

Federal Government to clean up sites at which hazardous substances have been released or deposited. Liability for the cost of the cleanup operation rests upon the "owner or operator" of the site concerned. The definition of "owner or operator" excludes a person who, "without participating in the management of the facility, holds indicia of ownership primarily to protect his security interest in the . . . facility"[68] (the secured lender exemption). Despite its apparently plain purpose, some court decisions have given a restricted interpretation to the secured lender exemption;[69] both Congress and the Environmental Protection Agency have made recent moves to strengthen the exemption. (A new rule was introduced by the agency in April 1992.)[70]

The EC has been considering its own rules, the most recent being the Amended Proposal for a Council Directive on Civil Liability for Damage Caused by Waste.[71] The European Commission has issued a "green paper"[72] on the remedying of environmental damage—not merely damage caused by waste—within a single legal framework.[73] Consultations on these proposals are taking place. The indications from the U.K. Government are that banks cannot expect special treatment.

In U.K. domestic law, the Environmental Protection Act, 1990,[74] introduced a new system of integrated pollution control for industry "for the purpose of minimizing pollution of the environment due to the release of substances into any environmental medium."[75] Section 61 imposes certain duties on local authorities to clean up polluted land, and gives such authorities the right to recover the cost incurred in doing so from the person who is for the time being the owner of the land.[76] It seems clear that a bank could not be an owner for these purposes merely by virtue of holding a mortgage over the land, except (perhaps) if it has taken possession of the land following the borrower's default, or possibly in other circumstances in which it exercises a degree of control. There are other potentially relevant provisions under this and other statutes (such as the Water Resources Act, 1991,[77] in respect of water pollution), but in general it is believed that the circumstances under the present law in which a bank will incur liability for its borrower's pollution will be rare.[78]

Consumer Protection

A healthy banking system requires the prompt and efficient enforcement of debts through the courts. The English system has, on the whole, a good record in this respect and is generally unreceptive to unmeritorious defenses and speculative claims. The virtual absence of the jury in the trial of civil claims is an important contributing factor. Nevertheless, the recognition of basic consumer rights is increasingly emphasized, and

three topical developments will be discussed in this section of the chapter. Issues of balance come into play here, also; it is not in the interests of consumers to place unreasonable burdens on the banking industry. What has come to be firmly recognized, however, is that good consumer relations in the context of fair customer contracts contribute importantly to the successful conduct of banking business.

Protection of Guarantors

A series of conflicting Court of Appeal decisions on the protection of guarantors has culminated in an important judgment of the House of Lords.[79] The case concerned the position of a wife securing the guarantee of her husband's business debts on the family home, but the reasoning is applicable to other cohabitees, as well. Although ordinarily a creditor owes no duty of care to a surety, it was held that, because a guarantee of a husband's business debts is not to a wife's advantage and because of the risk of wrongdoing by her husband, the creditor had a responsibility to inquire into such possible wrongdoing. In those circumstances, if the guarantee was obtained by the husband by undue influence or misrepresentation, the bank would be unable to enforce the guarantee unless it took reasonable steps to see that the wife's consent was properly obtained.

What amounts to "reasonable steps" for these purposes? For past transactions (that is, those entered into before the case was decided), it will depend on whether the creditor took steps to bring home to the wife the risk that she was running by standing as guarantor and advised her to take independent legal advice.

As to future transactions, a bank will be considered to have taken reasonable steps if it warns the wife (at a meeting not attended by the husband) of the amount of her potential liability and of the risks involved, and if it advises her to take independent legal advice. The court made it clear in a companion case[80] that these principles do not apply when a wife obtains a joint loan with her husband. What distinguishes this companion case from the surety case is that in the latter there was not only the possibility but also the increased risk of undue influence having been exercised because, at least on its face, the guarantee by the wife of her husband's debt was not in her financial benefit.

Despite some broad early decisions, it is believed that the courts will construe these principles relatively narrowly. For example, it has recently been stressed that a fair balance must be struck between the need to protect wives (and others in a like position) and the need to avoid unnecessary impediments to using the family home as security. It will generally be

sufficient for a bank to urge a proposed guarantor to take independent advice from a lawyer. How far the lawyer should go in probing the matter and in giving advice is a matter for the lawyer's professional judgment and a matter between lawyer and client, in which the bank is not generally involved.[81]

Legislation Against Unfair Contract Terms

On the wider level of consumer protection, English law has for many years invalidated unfair contractual terms in consumer contracts[82] and thus been capable of affecting banking contracts. For example, it has been said that a clause in a guarantee holding the guarantor liable for more than the principal debtor may be invalid.[83] However, the EC Directive on Unfair Contract Terms in Consumer Contracts[84] goes considerably farther than anything seen to date. It will apply to contracts for the sale of goods and the supply of services to a consumer. The precise scope of the directive on banking business is unclear, but all consumer banking services may be covered. The provisions of this directive came into effect on December 31, 1994.

Article 3 of the directive apparently introduces into English law for the first time the civil law concept of "good faith" in the performance of contractual obligations. Hitherto, the law has looked exclusively to the terms of the agreement on the basis of the doctrine of freedom of contract. However, Article 3(1) provides that "[a] contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer." The width and uncertainty of this provision has concerned the banking industry.

A broad welcome should, however, be given to Article 5, which provides that, in the case of contracts where all or certain terms offered to the consumer are in writing, "these terms must always be drafted in plain, intelligible language": a challenge for lawyers, indeed! The article goes on to provide that "[w]here there is doubt about the meaning of a term, the interpretation most favorable to the consumer shall prevail."

Code of Practice

A concrete and constructive response to consumer pressure has come from the banking industry itself. The Code of Banking Practice[85] is a voluntary code drawn up by the British Bankers Association, the Building Societies Association, and the Association for Payment Clearing Services, which is to be observed by banks, building societies, and card issuers in

their relations with personal customers. The second edition of this code came into effect on March 28, 1994. The code does not have the force of law, although the courts are likely to have regard to its provisions when considering the extent of banks' legal liability.[86]

The Code of Banking Practice seeks to set out standards of good banking practice. It stipulates that banks will (i) act fairly and reasonably in all their dealings with their customers, (ii) help customers to understand how their accounts and other banking services operate, and (iii) strive to maintain confidence in the security and integrity of banking and card payment systems. These very general principles are given effect to in the body of the code. Written terms and conditions of a banking service are to be expressed in plain language and provide a fair and balanced description of the relationship between customer and bank. Reasonable notice of variations is to be given to the customer. Much-improved details of bank charges and interest rates were already given under the first edition of the code. Banks are to have in place internal procedures for handling customers' complaints, and if the complaint remains unresolved, the customer may refer the matter to the independent Banking Ombudsman Scheme.[87]

The code reaffirms the principle that, in the absence of express written consent, details of customers' accounts must be kept confidential save where the law permits or requires, including in respect of companies in the same group (for example, insurance sales organizations).

The Code of Banking Practice provides for liability for loss in the event of misuse of credit or debit cards. It seeks to balance the interests of card issuers and customers by limiting customers' liability for unauthorized transactions to a maximum of £50, save where the customer has acted fraudulently or with gross negligence. In the case of disputed transactions, the burden of proving fraud or gross negligence will lie with the card issuer.

Jurisdiction, Governing Law, and Sanctions

This final section of the chapter deals with three allied private law topics that are important for banks and have been the subject of significant recent developments.

Civil and Commercial Jurisdiction

Within Europe, jurisdiction in civil and commercial matters is now governed by the Brussels Convention (in respect of EC members)[88] and the substantially identical Lugano Convention (in respect of EFTA members).[89] The principal rule of these conventions is that defendants are to

be sued at the place of their domicile, although the English courts will have jurisdiction in matters relating to a contract if England was the place of performance[90] and in matters relating to tort if England was the place where the damage or the event that gave rise to the damage occurred.[91] Where the conventions do not apply, the English jurisdictional rules (which in most respects are similar) continue to apply. In international transactions, there will, of course, almost invariably be jurisdiction clauses, which are given effect to under the convention rules.[92]

Governing Law and the Rome Convention

There will also almost invariably be choice-of-law clauses; again, such clauses remain fully effective. In respect of contracts entered into after April 1, 1991, the law governing contractual obligations is determined under the provisions of the EC Convention on the Law Applicable to Contractual Obligations (the Rome Convention).[93] Many of the principles in the Rome Convention are not significantly different from the common law rules;[94] the basic rule is that, to the extent that the applicable law has not been chosen by the parties, a contract is governed by the law of the country with which it is most closely connected.[95]

Bank accounts, including foreign currency accounts, are frequently operated without any express choice of law. In pre-Rome Convention cases, the English courts generally ruled that the law governing a bank account is the law of the place where the account is kept (in the absence of agreement to the contrary).[96] The position under the Rome Convention is somewhat more complicated, because the basic rule—that a contract is governed by the law of the country with which it is most closely connected—is qualified by a number of (rebuttable) presumptions. It is presumed that the contract is most closely connected with the country where the party that is to effect "characteristic performance" has its central administration. In respect of a bank account, the bank should probably be regarded as such a party. However, if the contract is entered into in the course of that party's trade (which will be the case as regards a bank opening an account), the governing law will be that of the country in which the party's principal place of business is situated; where performance is to be effected through a place of business other than the principal place of business, the governing law will be that of the country in which that other place of business is situated.

These presumptions do not readily lend themselves to the obligations created by bank accounts. However, it is believed that characteristic performance in respect of a bank account should be regarded as "to be effected through" the branch where the account is kept. If so, it is the law of the country where that place is situated that should govern the con-

tract, as under existing English law. This view appears to be consistent with the *traveaux préparatoires* to the Rome Convention,[97] which state that "in a banking contract the law of the country of the banking establishment with which the contract is made will normally govern the contract."[98]

A number of recent English cases have considered the law governing bank guarantees in the absence of a choice-of-law clause. Frequently, a bank guarantee is issued to the beneficiary (for example, the employer under a construction contract) against a counterguarantee issued by a bank in the advising party's home state. Therefore, two separate instruments must be considered. It has been held that the bank guarantee is ordinarily governed by the law of the place where payment is to be made under it.[99] However, as the place of payment may depend simply on the currency of the instrument concerned, more recent cases have held that the law governing counterguarantees should not depend on the place of payment, but should follow the law governing the guarantees because the natural expectation of the parties is that the two instruments would be governed by the same law.[100] In post Rome-Convention cases, the result may not be the same, given the examples in the *traveaux préparatoires* to the effect that, in a contract of guarantee, the characteristic performance is that of the guarantor.[101]

Effect of Sanctions on Banking Contracts

The final topic is an appropriate one for an international gathering. In a number of recent cases, the English courts have had to consider the effect of sanctions on banking contracts. Different results have been reached, depending on whether the sanctions were considered to be the unilateral acts of another state or to have been incorporated into English law.

Where unilateral sanctions are imposed by state A on state B, bank accounts held by citizens of state B in the United Kingdom will be unaffected, even if held in the currency of state A, because the accounts are governed by English law and performance in the United Kingdom is lawful under English law. An opposite result may be reached in a case involving international sanctions that have been incorporated into U.K. law.

The first of these principles is exemplified by cases concerning the sanctions imposed on the Socialist People's Libyan Arab Jamahiriya by the United States in January 1986. The Libyan plaintiffs maintained current accounts in New York and deposit accounts in London that were denominated in U.S. dollars. By agreement, amounts in excess of a "peg" were transferred from New York to London on a daily basis. The account hold-

ers not only recovered judgment for the sums on deposit in London, but also won damages for such amounts, as the banks concerned had failed to transfer to London in breach of the agreement made prior to the imposition of sanctions.[102] Illegality under U.S. law was no defense for the defendant banks (which were both U.S. banks).

Opposite results have followed in cases of UN sanctions that have been incorporated into U.K. law. For example, the English courts have recently refused performance of a counterguarantee in favor of a Libyan bank, applying the provisions of the Libya (United Nations) Sanctions Order, 1992.[103] The English courts have also refused to interfere with the operation by the Bank of England of UN sanctions against Serbia and Montenegro.[104]

Where sanctions do apply to prohibit payment of deposits, the effect is suspensory; the contracts are not frustrated.[105] In practice, it seems that most recent sanctions orders permit the crediting of interest to frozen accounts at commercial rates.

Chapter

14 Banking Law Developments in Canada

GUY DAVID

Introduction

The technology-driven globalization of the financial markets has created similar problems and concerns for regulators throughout much of the world. In Canada, policymakers have responded by looking beyond national borders in search of solutions. Their perception is that it is no longer possible for any country with an open market economy to legislate and regulate in a vacuum. In an increasingly integrated marketplace for financial services, the maintenance of a stable and sound financial system, the fostering of competition, and the protection of depositors and consumers require a coordinated international approach. Banking law and regulation have evolved rapidly in Canada over the past few years, as in other jurisdictions.

In a 1985 policy paper,[1] the Canadian Government enunciated nine principles that would form the basis for financial sector policy in the years to come. The principles received widespread approval. They were reaffirmed in a 1987 policy paper[2] and ultimately became the basis of financial sector policy that was implemented through legislative reform in 1991.[3] The principles are as follows:

- improve consumer protection;
- strictly control self-dealing;
- guard against abuses of conflicts of interest;
- promote competition, innovation, and efficiency;
- enhance the convenience and options available to customers in the marketplace;
- broaden the sources of credit available to individuals and business;
- ensure the soundness of financial institutions and the stability of the financial system;
- promote international competitiveness and domestic economic growth; and

- promote the harmonization of federal and provincial regulatory policies.

These principles have been applied to the various types of regulated financial institutions: banks, trust and loan companies, insurance companies, investment dealers, and financial cooperatives.

This chapter will provide an overview of the Canadian financial system and then examine the legislative and regulatory framework governing four broad areas that are of general interest to central banks and regulators around the world. These are (i) the institutional structure of the financial system; (ii) foreign access to the Canadian market; (iii) financial and commercial linkages; and (iv) solvency, deposit insurance, and consumer protection.

Overview of the Canadian Financial System

Canada is in the middle of the geopolitical world, bordering on the United States to the south, Europe to the east across the Atlantic, the Pacific Rim and Asia to the west, and Russia, the Baltic countries, and the other countries of the former Soviet Union to the north across the Arctic. However, this location had little impact on the development of the financial system until quite recently.

Canada shares a long border with the United States. In fact, this border is over 4,000 kilometers long, approximately twice the distance as that from Paris to Moscow. Ninety-six percent of Canada's 27 million people live in a narrow 200–kilometer band stretching from the Atlantic Ocean to the Pacific Ocean along this border. This population distribution more than anything else has led to development of a branch-based banking system, with a limited number of large domestic banks maintaining hundreds of branches.

Canada comprises ten provinces. It is a federal state, with powers over the financial system shared between the Federal Government and the provincial governments. This structure, too, has had and continues to have a very significant impact on the structure of the financial system and the development of banking regulation.

The Federal Government exercises jurisdiction over banks, federally incorporated trust and loan companies, insurance companies, and foreign-owned banking institutions. The provincial governments have jurisdiction over the securities industry, provincially incorporated trust and loan companies, and provincially incorporated cooperative banks (called credit unions and *caisses populaires*). Deposit insurance is administered by the Federal Government for both federally regulated and provincially reg-

ulated deposit-taking institutions, except in the province of Québec, which has its own system for Québec-incorporated institutions, and except for the credit unions and *caisses populaires*, which adhere to provincial deposit insurance schemes. The Federal Government also regulates the clearing and settlement system.

There are approximately 9,300 branches of deposit-taking institutions in Canada, which is more than one branch for every 3,000 people. There are also 16,000 automated banking machines, which amounts to more than two machines for every 3,000 people. Every day the clearing and settlement system processes approximately 9 million items, that is, one item for every three people. Canadians do a lot of banking. As of December 31, 1993, total assets of the deposit-taking institutions were approximately Can$850 billion, and total assets of the insurance industry amounted to approximately Can$159.3 billion. Of the total assets of deposit-taking institutions, approximately 60 percent were held by banks, 25 percent by trust and loan companies, and 15 percent by credit unions and *caisses populaires.*

Institutional Structure of the Financial System

"Four Pillars"

Historically, the Canadian financial industry was said to comprise four pillars: (i) the banks, (ii) the investment dealers or securities industry, (iii) the insurance companies, and (iv) the trust companies. One might also add a fifth pillar, the cooperative credit unions and *caisses populaires.* The industry was regulated on institutional lines, with functional and investment prohibitions aimed at preserving the distinctions among the pillars. For example, banks could not engage in the securities business or the business of insurance, and they could not undertake fiduciary activities. Likewise, insurance companies and investment dealers could not accept deposits, although the securities industry was able to circumvent this prohibition by offering various accounts to the public in conjunction with deposit-taking financial institutions. Trust companies have always been entitled to take deposits, but traditionally their commercial lending powers have been constrained.

In the most recent legislative reform, Canadian financial institutions were given a number of overlapping core powers, with some restrictions maintained for competitive, prudential, and jurisdictional reasons. The core powers are examined below.

Deposit Taking

Both banks and trust companies, as well as credit unions and *caisses populaires*, are entitled to accept checkable and uncheckable deposits. Insurance companies are prohibited from taking deposits, although exceptions are made for deposits that are considered to be related to insurance products, such as life annuities. However, there is an important legal distinction between bank and trust company deposits. Bank deposits are unsecured liabilities of the bank, which rank pari passu with all other liabilities, while trust company deposits are not liabilities per se, but are deemed to be held in a guaranteed trust fund that ranks ahead of the unsecured liabilities of the trust company. Because both types of deposits are covered by the same deposit insurance, this inequality does not create an advantage for the trust companies in attracting deposits; however, it creates a disadvantage for the trust companies in accessing the capital markets with other debt instruments because these market instruments rank behind the trust deposits on insolvency rather than pari passu with the deposits, as in the case of bank-issued paper.

Commercial Lending

Both banks and trust companies have access to unrestricted commercial lending powers, as do the insurance companies. However, trust and insurance companies are required to meet certain capitalization thresholds or obtain regulatory approval, or both, before engaging in unrestricted commercial lending. Financial institutions have the power to give guarantees, but these must be for a fixed sum of money; moreover, the person on whose behalf the guarantee is given must have an obligation to repay the sum guaranteed. The cooperative financial institutions have very restricted commercial lending powers, although the trend in several provinces is to increase these powers.

Fiduciary Activities

In most provinces, only trust companies are entitled to engage in fiduciary activities in-house, although banks and insurance companies may own trust company subsidiaries. However, certain provinces have extended fiduciary powers to credit unions or *caisses populaires.*

Insurance

Banks and trust companies are prohibited from selling insurance, either directly or through networking or referral arrangements. Life insurance business and property and casualty insurance business must be carried on

by separate insurance companies. The credit unions and *caisses populaires* have certain powers to retail—but not to write—insurance. This capacity puts them in limited competition with facets of the insurance industry.

Leasing

Financial institutions are prohibited from engaging in the leasing of automobiles, household goods, and other consumer goods, so as not to compete with the retail industry, which sells or leases these products to the public. The argument has been made before legislative committees that consumer leases are essentially a financial product and a credit substitute, which financial institutions should be entitled to offer their customers. However, most financial institution legislation continues to prohibit "dealing in goods." If one takes an economic view of leasing consumer goods, it is not clear that the prohibition of dealing in goods is sufficient to prevent the leasing of consumer goods by financial institutions. To avoid doubt, therefore, consumer leasing is specifically prohibited in many financial institution statutes.

Affiliation, Concentration, and Competition in the Financial Services Industry

In Canada, the institutional pillars have been preserved for regulatory purposes, but functional restrictions have largely been eliminated. This has been accomplished in part not only by sharing many "core" powers, as noted above, but also by permitting financial institutions to affiliate and, more specifically, by allowing the banks to own or control investment dealers, trust companies, and insurance companies. To fully appreciate what is happening, one must bear in mind that the Bank Act[4] requires that domestic banks be "widely held," that is, no single shareholder or group of connected shareholders may own more than 10 percent of the voting shares of a bank. There are exceptions to this rule for small start-up banks. Similar rules do not apply to the other "pillars" of the financial services industry. When the rule prohibiting banks from owning investment dealers was relaxed in the mid-1980s, it did not take long for most of the securities industry to be taken over by the banks. The law still requires that securities activities of banks be conducted through securities subsidiaries, but it can be expected that this requirement will become anachronistic with time and will eventually be eliminated. The only remaining factor protecting the bank-owned securities industry from extinction is that jurisdiction over this part of the financial services industry is granted under the Constitution to the provinces and not the Federal Government.[5]

The trend toward concentration that transformed the securities industry has also overtaken the trust companies, although there have been other contributing factors in this case. In the mid-1980s, the rule prohibiting commercial enterprises from owning trust companies was relaxed. Quickly thereafter, some of the major trust companies, which had previously been widely held, were taken over by large commercial companies. There followed the recession and the devastation of the real-estate-based loan portfolios of these companies. Under the guidance of their new commercial owners, these trust companies had invested heavily in real estate loans and, to the extent permitted, in real estate equity. Very few healthy trust companies remained after the recession, and several had already been merged with banks in order to avoid liquidation. When the rule against bank ownership of trust companies was eliminated in the late 1980s, it did not take long for the few remaining non-bank-controlled trust companies to be acquired by the banks, such that only one large independent trust company remains today.

In the 1991 revision of financial sector legislation, the power of the banks to engage in the business of insurance has been constrained to protect the insurance companies from bank competition. However, the banks have been given the power to own or control stock insurance companies. At present, the Canadian insurance industry is greatly in need of capitalization. Many of the larger insurance companies are mutual companies, owned by their policyholders rather than by shareholders. In order to capitalize to support growth, many of these companies will "demutualize," as permitted by the Insurance Companies Act. With demutualization, one can expect that a large segment of the insurance industry will eventually be owned by the banks.

Given the permissive legislative and regulatory framework, this ongoing concentration appears unlikely to abate until the major banks control the entire financial services industry. While a domestic competitive response to the banks is not likely, there are already indications that some of the foreign bank subsidiaries will broaden the scope of their activities to compete with the domestic banks in areas that the Canadian banks now control.

Foreign Access to the Canadian Financial Services Market

Foreign ownership in the financial sector has been a long-standing issue in Canada. Although the system was opened to foreign banks in the early 1980s, most types of financial institutions continued until quite recently to be governed by legislation that restricted foreign ownership. The general rule for ownership of banks operating in Canada is that no

single person or group may own or control more than 10 percent of the voting shares of the bank and nonresidents as a whole may not own or control more than 25 percent of the voting shares of a bank. However, there are two important exceptions to this rule, one applicable to foreign banks (and, more recently, to other foreign financial institutions, provided that they are widely held), and the other applicable to Canadian financial institutions. An eligible foreign institution may have a wholly owned Canadian bank subsidiary, subject to the following rules and limitations:

- the foreign institution must be either a bank or another financial institution that is widely held;
- the home jurisdiction of the foreign institution must offer treatment as favorable to Canadian banks operating in that country;
- the Canadian bank subsidiary of the eligible foreign institution must be wholly owned by it;
- the foreign institution must demonstrate that it will be capable of making a contribution to the financial system in Canada; and
- there must be room to accommodate the new entry under the limit of 12 percent placed on the share of aggregate Canadian assets of foreign banks in the domestic banking market.

These rules came about in 1981 when Canada opened its financial markets to foreign banks, and they were further revised by the 1991 banking legislation. When the Bank Act was amended to allow foreign financial institutions to enter the Canadian market by incorporating Canadian bank subsidiaries, minimum capitalization was set at Can$2.5 million, but, in practice, Can$5 million was required. The present capital requirement is CanS10 million.[6] Approval to enter the Canadian market is granted on a country-by-country and bank-by-bank basis. One of the factors to be taken into account by the licensing authority is that of reciprocity, that is, whether Canadian-owned banks enjoy treatment as favorable in the country of the foreign bank. To maintain a strong Canadian presence, a restriction has been imposed on the total participation market share of the foreign banks through individual asset and aggregate limitations. The total domestic assets of all foreign banks were initially limited to 8 percent of the domestic banking market. The cap was subsequently raised to 16 percent of the domestic market, but, under the North American Free Trade Agreement, U.S. and Mexican banks were excluded from the calculation, and the cap has been revised downward to 12 percent. At present, the total Canadian assets of foreign bank subsidiaries are between 11 percent and 12 percent of the domestic banking market.

There are now 56 foreign bank subsidiaries operating in Canada. The stated political rationale for opening the market in 1981 was that foreign competition would give customers better services at lower prices and facilitate Canadian bank access to foreign markets. While it is debatable whether markets have increased, it is generally acknowledged that the foreign banks have had a very limited competitive impact on the domestic market. This is due in part to their concentration on high-end syndicated corporate loans, commercial paper, and government securities; the foreign banks have not entered the so-called middle market of business loans, where it was hoped they would concentrate their activities. The exceptions have been banks from countries with large immigrant populations in Canada, which have concentrated on serving their Canadian ethnic communities.

Financial and Commercial Linkages in the Canadian Financial System

Holding of Bank Shares by Commercial Enterprises

Ownership policy has been one of the most effective tools in Canada for achieving public policy goals in the financial services industry. Canada has diverse forms of ownership of financial institutions, ranging from widely held institutions to closely held companies to member-owned cooperatives. To a great extent, ownership policy has been aimed at preventing takeovers of Canadian institutions by nonresidents.

Despite the belief that the Federal Government would use ownership restrictions to strengthen policies to curb self-dealing and the concentration of power, as well as to promote the integrity of the credit allocation process and Canadian control of financial institutions, ownership restrictions were, in fact, relaxed for all segments other than banks in the 1991 legislative reform.

A hotly debated topic flowing from the ownership policy is the question of financial and commercial linkages. The ownership of financial institutions by commercial enterprises raises concerns about concentration of ownership, self-dealing, reduction of competition, and conflicts of interest. However, it is not easy to answer the question of whether the existence or development of commercial links, in itself, has a bearing on the risk of insolvency of financial institutions. Many countries have structures that permit commercial links to financial institutions and allow closely held institutions to be the norm, yet their financial systems are stable. The Canadian approach has been to consider large, widely held financial institutions as the objective toward which financial institutions

should strive, while recognizing the need for exceptions in a less-than-perfect world.

As noted above, foreign bank subsidiaries are one exception to the rule that no single shareholder or connected group of shareholders may own or control more than 10 percent of the voting shares of a bank.[7] The Bank Act contains another exception, which applies to start-up banks resulting from either a new incorporation or a continuance (a procedure whereby another financial institution transforms itself into a bank). These institutions, which may be wholly owned by a single shareholder, have ten years in which to become widely held. Despite this exception, commercial enterprises do not have an absolute right to hold an interest in banks greater than 10 percent. The Bank Act specifies that, in exercising its discretion to permit the incorporation of a bank in which a person will have more than a 10 percent interest, the Department of Finance may "take into account any activities of the [shareholder] . . . of a non-financial nature."[8] The intention of this provision is to constrain, without prohibiting outright, situations in which a commercial entity will hold more than 10 percent of the shares of a bank.

The Bank Act also allows a Canadian financial institution that is not itself a bank to hold more than 10 percent of the voting shares of a bank whose capital does not exceed Can$750 million for more than ten years, provided that it controls the bank.[9] The shareholders of that financial institution may be commercial enterprises, but the financial institution itself may not have any substantial investments in commercial enterprises, except those in which a bank is entitled to invest directly.

In addition to the foregoing, when the capital of a bank in which a person has a significant interest reaches Can$750 million, the bank has five years to cause not less than 35 percent of its voting shares to be listed on a recognized stock exchange and to be held by shareholders who do not have more than a 10 percent interest in the bank.[10]

If a bank is not able to comply with the foregoing rules, it must transform itself into a trust company.[11] A trust company may be controlled by commercial enterprises or by other financial institutions. However, a trust company with capital of Can$750 million or more is subject to the requirement of a 35 percent public shareholding of listed shares (but not the 10 percent significant interest restriction), unless it is controlled by a widely held financial institution.

Investments in Commercial Enterprises by Banks

Most Canadian legislation now governing financial institutions has incorporated the "portfolio" or "prudent investor" approach. Under this

approach, each financial institution must establish and adhere to investment policies, standards, and procedures "that a reasonable and prudent person would apply in respect of a portfolio of investments . . . to avoid undue risk of loss and obtain a reasonable return."[12] This decree is coupled with quantitative rules on the composition of an institution's portfolio.[13] However, quality tests—so long a hallmark of Canadian legislation—have been done away with.

The Bank Act and other legislation governing financial institutions prohibit these institutions from having equity investments in excess of 10 percent in the shares of any commercial enterprise.[14] As noted previously, financial institutions may own or control other financial institutions operating in a different sector of the market. Financial institutions are also entitled to invest in a number of enterprises whose goods or services are more or less related to the business of a financial institution. Included in these permitted investments are corporations whose business is factoring, financial leasing, information services, investment counseling or portfolio management, mutual fund promotion or management, and property holding or management.[15] However, where a bank holds more than 10 percent of the shares of any such corporation, it must control the corporation. These investments by a bank in permitted subsidiaries may not exceed in the aggregate 100 percent of the regulatory capital of the bank.[16]

Solvency, Deposit Insurance, and Consumer Protection

Protection for savers and depositors has been one of the major policy trends of financial institution legislation and regulation over the past ten years. This trend is the result of countless failures in all sectors of the marketplace and the ever-increasing costs to the deposit insurance system and the public purse. One might ask whether governmental protection of the solvency of financial institutions continues to be a justifiable end. Why should the taxpayer support an expensive regulatory system that ultimately protects mostly the shareholders of financial institutions? Why should the taxpayer support deposit insurance schemes that protect deposit-taking institutions and their customers from consequences that these institutions largely bring onto themselves? Does government have a responsibility to protect savings in non-deposit-taking institutions? If not, why not?

In Canada, two reasons have been advanced by the Government in support of its greater involvement with the financial sector than with other facets of the economy. First, the financial sector occupies a central place in the economy through its role in the allocation of credit and as

the core of the payments system. Second, financial institutions are in a unique position of trust in handling funds belonging to the general public. These concerns, together with the experience gained from the mistakes of the past, have led to ever-increasing regulation aimed at preserving solvency, not only to protect consumers but also—and more important—to maintain the stability of the financial system as an end in itself.

Certainly, the most important lesson learned by policymakers, regulators, and the financial services industry itself from the failures of the 1980s is that deposit insurance alone is insufficient to preserve the stability of the financial system. The other lesson is that, without substantial improvement, the deposit insurance system in its present form will not survive. Canada, like many other countries, has taken measures aimed at reducing individual failures of financial institutions and thereby preserving solvency and stability. The most significant measures adopted in legislation affecting banks and other financial institutions in Canada include the imposition of the Basle Capital Accord, the implementation of controls against self-dealing and related party transactions, and adoption of the prudent investor standard for loans and investments. All of the above measures have been combined with a stricter reporting and supervisory regime.

Capitalization

As in most other industrialized countries, capital adequacy has preoccupied bank regulators in Canada—some would say for an inordinate amount of time—over the past few years. Variants of the Basle Capital Accord[17] apply to all federally regulated financial institutions other than property and casualty insurance companies. This regime comprises (i) the defining of capital, (ii) the risk weighting of assets, and (iii) the targeting of a ratio of 8 percent of capital to risk-weighted assets.

The major Canadian banks have all achieved the 8 percent target and are on average above 9 percent. The foreign bank subsidiaries are even higher as a group. The Canadian rules are quite stringent, compared with international standards.

Some technical adjustments have been made to the Basle rules as they apply to Canadian financial institutions. The definition of capital excludes certain forms of subordinated debt in the case of trust companies. For conversion of off-balance-sheet risks, the current exposure method is mandatory for establishing the credit conversion factor. Trust companies that lack a regionally or sectorally diversified portfolio are subject to higher ratios than the 8 percent minimum capital requirement and the

20:1 ceiling on the ratio of assets to capital. Rules are still evolving for derivatives and financial instruments related to securitizations, in particular, credit enhancements of securitization transactions.

Trust companies have traditionally been regulated on an unconsolidated basis in Canada whereas banks have been regulated on a consolidated basis. Assessment of capital adequacy requirements for trust companies is migrating toward a consolidated basis. Also, banks have traditionally been assessed on a going-concern basis whereas trust companies have been assessed on a liquidation basis, in which assets of little or no liquidation value are deducted. A shift toward a going-concern assessment for all financial institutions is taking place.

The basic Basle Capital Accord framework for assessing capital adequacy, as well as the setting of parameters for market risks, is well in place with respect to federally regulated financial institutions. The provincially regulated cooperative financial institutions are gradually migrating to the Basle Capital Accord framework from evaluation based on a fixed 4–5 percent ratio of capital to deposits. Certain transitional rules include lowering the initial minimum capital ratio to 6.5 percent, allowing a lower risk weighting for consumer loans (80 percent rather than 100 percent), and suspending implementation of rules for interest rate risk exposure.

It can be expected that the entire Canadian financial system will operate under the Basle Capital Accord framework within the next few years.

Control of Self-Dealing

In the latest revision of the Bank Act and other legislation governing financial institutions, strict controls were imposed on transactions between a financial institution and persons who are in positions of influence over, or control of, the financial institution.[18] Although previous legislation included controls on self-dealing, the rules were generally inadequate, and persons and entities involved in self-dealing could easily circumvent them. The new policy is based on a three-tier approach: a ban on most transactions with "related persons";[19] internal controls for some permitted transactions, which are generally for limited amounts and involve standard arrangements;[20] and prior approval from the regulator for special transactions.[21]

The following persons are considered as being related to a financial institution:

- shareholders who own, directly or indirectly, 10 percent or more of any class, or any series of any class, of shares;
- directors and officers of the financial institution;

- auditors of the institution;
- directors and officers of corporations who own, directly or indirectly, 10 per cent or more of any class, or any series of any class, of shares of the financial institution;
- members of the immediate family of the above; and
- the significant business interests of the financial institution or of the persons described above.[22]

In addition to the foregoing, regulators can designate individuals or corporations as being related to a financial institution, and they can exempt individuals from such status.[23]

Other Measures to Protect Solvency and Consumers

In the latest revision of its financial institution legislation, Canada adopted a number of additional internal governance measures applicable to all financial institutions. These measures include various provisions to avoid conflicts of interest, the strengthening of the role and liability of the external auditor, adoption of the prudent investor standard, and the placing of greater responsibility on directors, who have now been given the primary responsibility for overseeing the internal governance framework.

In addition to their general duty to manage and supervise the management of the bank (or other financial institution), the directors are obliged to

- establish an audit committee;
- set up a conduct review committee, which must approve all related-party transactions;
- establish procedures to resolve conflicts of interest, including techniques to identify potential conflict situations and restrict the use of confidential information;
- designate a committee of the board of directors to monitor the conflict-of-interest procedures;
- establish procedures to provide disclosure of information to customers of the bank to deal with complaints;
- designate a committee of the board of directors to monitor the information and complaint procedures and satisfy itself that they are being adhered to by the bank; and
- establish investment and lending policies, standards, and procedures in accordance with the prudent investor standard.[24]

Conclusion

The general thrust of recent Canadian legislative and regulatory policy has been to re-examine the traditional approach, so long in vogue, of assuring stability in the financial system by restricting the ability of banks to compete with other financial institutions, restricting the ability of non-bank financial institutions to compete with banks, and protecting depositors with generous deposit insurance, regardless of the risk and yield on those deposits. Although barriers remain, great strides have been made in allowing affiliation and competition among financial institutions serving different segments of the market. A price has been paid for this breakthrough in the form of greater concentration, which inevitably heightens concerns about systematic risks. To a large extent, the traditional controls have been replaced by more stringent internal governance requirements and a tighter regulatory framework.

It is not clear yet whether these developments have led to a more even playing field for the different types of institutions and to greater competition—and, hence, better service—for the customer.

The new, strengthened internal governance regime is likely to have a significant effect on the conduct of financial institutions. The Canadian courts have not yet had occasion to interpret the prudent investor test. However, experience elsewhere would lead one to conclude that the prudent investor standard—and the resulting liability of directors for failure to observe it—may be a powerful deterrent to improvident loans and investments.

Given the fast-changing nature of the financial world, some observers may ask whether the steps taken by Canadian policymakers may risk impeding the development of the kind of dynamic and efficient financial system that the economy needs to grow and prosper. Is too much being sacrificed in the name of soundness and consumer protection, thereby preventing market forces from playing their important role in shaping the financial system? Only the future can tell whether the right balance has been struck.

COMMENT

MELANIE L. FEIN

The two preceding chapters describe how the banking systems of the United Kingdom and Canada are confronting changes in the foreign financial services marketplace, as well as in their own domestic financial marketplaces. Even though the two banking systems are quite different in certain aspects, there appear to be some salient common themes in how each system is evolving and in the types of financial supervisory and regulatory issues that each is confronting. Some comments on the U.S. banking system would help give a broader context to the discussion and bring into clearer focus how the Canadian and the U.K. banking systems compare with another major world banking system.

At least four general themes or trends are apparent in the banking systems of Canada, the United Kingdom, and the United States. These trends have been under way for a number of years and have reached a mature state in some cases. The United Kingdom, for example, already appears to have attained self-regulation, whereas the United States and Canada are not quite so far along. In other areas, the United States or Canada has led the way.

Breaking Down Geographic Barriers

First, there has been a general breakdown of the geopolitical boundaries that formerly excluded foreign competition from national banking markets, as well as a breakdown of internal barriers to geographic expansion. This trend is evident in Canada in the increased opportunities for foreign access to the Canadian banking market, resulting from changes in Canadian law in the early 1980s, the Canada-United States Free Trade Agreement,[1] and the North American Free Trade Agreement.[2] In the United Kingdom, this theme is evident in the application of the Second Banking Directive of the European Community,[3] which effectively creates a European banking license under which banks in the European Union can operate with ease across national boundaries. In the United States, a national treatment policy, with open access to foreign competitors operating in the United States, has long been in effect.[4] The U.S. trend seems to be more internal than external. Interstate banking by bank holding companies has increased dramatically as a result of changes in the laws of the individual states. In addition, the U.S. Congress has enacted legislation that eliminates federal barriers to interstate branching.[5] So, in

all three banking systems, the elimination of geographic barriers to the provision of banking services seems to have been a consistent theme over the past decade.

Consolidation

The second theme is the consolidation of the financial services industry, that is, the combining of the banking, securities, and insurance sectors through common ownership and other relationships. This trend is evident in the changes in Canadian law in the mid-1980s that allowed banks to acquire securities firms, insurance companies, and trust and loan companies.[6] In the United Kingdom, to the extent that there ever was a legal separation between commercial banks and securities firms or investment banks, this barrier was lifted in the so-called Big Bang of the mid-1980s. In the United States, the law has been interpreted to permit banks and bank holding companies to acquire securities firms and to engage in the sale of insurance nationwide through networking and referral arrangements, as well as from small towns (the so-called town-of-5,000 loophole). The United States probably has the most restrictive law, the Glass-Steagall Act,[7] which historically has separated the banking industry from the securities industry. Even though this law is still on the books, however, it has failed to stop this trend.

In each of the three countries, barriers to competition among different types of financial institutions are being removed, and legal distinctions among them are blurring. In each country, nonbank financial service firms are actively engaged in lending and other credit activities. Banking institutions increasingly are involved in providing nontraditional financial services, including securities and insurance activities and leasing. The role of banks is becoming significantly broader, and the definition of "banking business" is expanding. It might be fair to refer to the "financial services industry" as a separate generic industry, rather than to the "banking industry" or the "securities industry" or the "insurance industry." Although it has not quite occurred yet, one can expect to see in the future a continuing consolidation of the different financial sectors into a single industry.

Self-Regulatory Measures

The third trend is the increase in self-regulatory measures in the form of new emphasis on policies and procedures and the role of the board of directors of financial institutions. This trend is noticeable in Canada, the United States, and the United Kingdom, the latter of which has had a long tradition of self-regulation.

The governmental regulatory authorities in these countries are by no means relinquishing their regulatory jurisdiction. However, the consistent theme is to encourage or to require banks to create policies and procedures to deal with, for example, the monitoring and managing of risk, conflicts of interest, and money laundering, and to respond to customer complaints and strengthen customer protection through the creation of internal audit committees. Instead of requiring that loans or investments be directed to certain sectors or subject to specific limits, Canada now requires the banks to adopt policies and procedures to ensure that they invest their funds as would a prudent investor.[8]

This third trend represents a particularly healthy development. Rather than dictating rigid, across-the-board solutions to problems, the role of government increasingly is to identify specific problem areas and to allow or to require each bank to develop its own policies and procedures for dealing with the problems as they affect that particular institution.

The preceding three common themes in the banking systems of Canada, the United Kingdom, and the United States suggest a number of interesting issues for further discussion. For example, what type of regulatory structure is most appropriate for a consolidated financial services system? Is it functional regulation, where banking, securities, and insurance functions are regulated separately? Is it entity regulation, where a conglomerated financial services organization is regulated on a consolidated basis? Or is it some combination of functional regulation and entity regulation? This debate is unfolding in the United States. The U.S. Congress has held hearings on the regulation of bank securities activities in the marketing of mutual funds, focusing in particular on whether the Securities and Exchange Commission or the banking agencies should primarily regulate these activities.[9] The banking regulators favor entity regulation, whereas the SEC favors functional regulation. What probably will continue is a combination of the two types of regulation.

Another question is, What is the role of a nation's central bank in a consolidated financial services system? Should the central bank be the supervisor and regulator of financial conglomerates that include not only banks but also securities firms and insurance companies? The role of the central bank in the United States has been heavily debated over the past year, with the result that the central bank (the Federal Reserve System) most likely will continue to play a significant role in banking supervision and regulation. This role also will likely extend to the supervision of banks, to the extent that they engage in securities and insurance activities. The federal banking regulators have made clear that they intend to play a role, but that they will also respect the right of other agencies to regulate on a functional basis where the latter have jurisdiction.

Other questions remain. What are the implications for systemic risk of a consolidated financial services industry within a single country, as well as within the global financial market? How is each country dealing with such risk? How does each system regulate relations between banks and their affiliates? How does each system coordinate supervision and regulation of banks operating across geopolitical boundaries? What capital requirements should apply to a consolidated financial services entity?

Social Responsibility

The fourth, and final, theme is the increasing recognition that banks have a social responsibility. In the United Kingdom, a new emphasis has been placed on the responsibility of banks as owners of property under environmental protection laws. Certainly, there is also a very great focus on that issue in the United States. In fact, legislation has been pending before Congress specifically addressing the responsibility of banks and the limits on their liability for environmental cleanup costs.[10] In the United Kingdom and Canada, consumer protection is increasingly emphasized.

The United States is the leader in this area. Arguably, the United States has the most stringent consumer protection laws in the world. Many banks feel somewhat overburdened by their responsibilities in this area. The United States enforces not only consumer protection laws but also affirmative obligations on banks to lend money to low-income areas.[11] This is a subject to which the Administration has given some priority in its legislative agenda. Congress passed legislation in 1994 authorizing community development banks,[12] and it is expected that debate will continue in the United States about the obligation of banks to allocate credit to low- and moderate-income areas.

Of final note is money laundering, an area that all banks undoubtedly will be asked to focus on for the purposes of crime control. It is a form of social responsibility, to the extent that banks are being asked to participate in crime control. There has been an increased focus on money laundering in the United States,[13] as well as in the United Kingdom[14] and Canada.[15]

Conclusion

It is extremely important to the continuing development and improvement of the U.S. banking system, as well as of the global banking system, to share and discuss information about banking systems around the world. The exchange of information and ideas on issues of mutual concern is for the mutual benefit of all.

Chapter 15 Banking Law Developments in the Former Soviet Union

TONY SHEA

Economic and Banking Environment

Paying special regard to events in the Russian Federation, this chapter briefly examines some of the developments in banking laws in the Baltic countries, the Russian Federation, and the other countries of the former Soviet Union. It is necessary to recall the environment in which banks in the region operate. Originally, there were a few large, specialized banks. Some of these, in one form or another, still exist. Where the large banks had branches in republics other than Russia, they were taken over by the newly emerging countries. In addition to those original banks, the system now has a number of smaller banks, some very small indeed. In Russia, there are over 1,700 banks, but 65 of these make up two-thirds of the system.[1] Many cannot meet the existing capital requirements, which were recently increased, and some closures or mergers are expected.[2] The largest bank in Russia, in terms of assets, was the savings bank, Sberbank, but this is now second or third in that category.[3]

There are some joint-venture banks, co-owned by Russians and foreigners, and a handful of Western banks have full banking licenses. The previous Parliament had proposed that new foreign banks should not be permitted in Russia, that existing foreign licenses should be reviewed, and that existing foreign banks, if allowed to stay, should be permitted to deal only with foreigners. This proposal was supported by many Russian banks, on various grounds, most of which amounted to fear of competition, but it was resisted by the Central Bank, the Government, and the banking subcommittee of Parliament, on the grounds that such competition—and new ideas, skills, and capital—were just what the system needed.[4] President Yeltsin originally vetoed the Parliament's decision, but then passed decrees limiting by law the total capital of foreign banks to 12 percent of all Russian banks and imposing geographical restrictions on such banks.[5] A freeze on new licenses was also imposed, although the Central Bank seems to some extent to have circumvented this. These restrictions were introduced shortly before a referendum in April 1993. They were the subject of some discussion, particularly with the European Community (EC), with which Russia subsequently reached an economic agreement.[6]

In 1995, the law restricting foreign access was scheduled to be abolished, and the 1993 decree immediately ceased to apply to the five banks operating already. Newcomers and existing banks now receive national treatment (with some exception, such as the level of minimum capital). After five years, the 12 percent limitation will be reviewed. Similar restrictions have not been imposed in most other countries of the former Soviet Union, which are far more welcoming of foreign bank capital.

The securities market is only embryonic, and most enterprises raise funds from the banking system, which, in turn, is funded largely by the Government or central bank credits. However, since 1992, one of the main sources of financing of enterprises has been mutual default on payments. Most large enterprises in most of the countries are heavy loss-makers, although few have so far been made insolvent—either from inertia, fear of unemployment and unrest, or the simple lack of appropriate laws and skills.

In developed market economies, the public—ordinary people as well as private businesses—is the major source of the funds that are allocated by the banking system. Most people and businesses have bank accounts into which they put their savings. This is not yet the case in the Commonwealth of Independent States (CIS). Only in a few regions are significant amounts of bank funds collected from ordinary people and private businesses. Most people with bank accounts have them with Sberbank, although in some regions other commercial banks are acquiring deposits from the public.

Although the situation is changing now and will change more rapidly with increasing privatization, most bank funding in Russia has come from the Central Bank, which channels funds through commercial banks to particular state enterprises.[7] The Central Bank, in turn, gets its money either from the Government or Sberbank, or by printing money. A limited amount of funding is obtainable from an interbank deposit market. Largely because of high inflation rates and the manner in which banks fund themselves, lending is very short term and at high rates of interest, which, however, lag behind the inflation rate.

Sberbank has been the organization best known to ordinary people and the one in which they have traditionally saved their money. This institution is subject in Russia to direction from the Central Bank, which has also controlled its lending activities.[8] The deposits of Sberbank have a significant advantage because they are guaranteed by the state, while those of other banks are not.[9] Sberbank has 40,000 branches (90 percent of the branch network of all banks) and over 90 percent of household deposits.[10] It offers a variety of services that other banks do not offer.[11] Public familiarity, plus its unlimited guarantee and its branch network,

gives Sberbank a huge potential advantage over other banks in reaching the ordinary public.

In the CIS as a whole, judging creditworthiness has not been required of banks. Banks have usually allocated central funds to state enterprises by direction. If the funds were not repaid, they were routinely written off. This practice is now changing, but establishing proper procedures to assess credit is very difficult because of the lack of professional experience in judging creditworthiness and the lack of the accounting standards and experience needed to facilitate risk assessment. Change is also difficult because, with much bank lending tied to the founders of the banks, there is no incentive (or ability) to judge their creditworthiness.

In the West, the notion that banks are more highly regulated than ordinary commercial companies is familiar. Banks are not controlled, but they are highly regulated. This concept is either not widely understood by bankers in the CIS, or, if understood, it is often not accepted. A common complaint of bankers is that, now that there is a free market, banks should, like other companies, be free. Although the bankers in one sense are underregulated, there is perhaps some justification for some of the complaints, as even the Central Bank of the Russian Federation will agree that it has introduced many new requirements and changed others with little notice, causing great resentment among the commercial banks.

Specific Prudential Rules

Capital

The minimum capital for banks in Russia was increased, roughly in line with the twentyfold increase in prices, from Rub 100 million to Rub 2 billion.[12] This amount is still low, but it is aimed before the end of the century to increase it to the EC standard of ECU 5 million.[13] In other newly emerging countries, the figure for bank capital is often much lower. Often, moreover, the definition of capital is highly unsatisfactory. Although initial capital may have to be deposited in cash with the central bank or elsewhere, on an ongoing basis, contributions in kind, such as buildings or equipment, can often be counted as bank capital, and such contributions can be valued by the bank itself at shareholders' meetings. (The idea behind this practice is that capital forms the basis for the distribution of dividends.) Furthermore, intangible property, such as know-how, may be counted as capital. In addition, capital forms the basis of a gearing ratio for lending exposures of about 20:1. The idea now commonly accepted in the West, that a fund of capital should be retained to meet losses, is not applied in the countries of the former Soviet Union. All

of the capital not tied up in buildings and equipment can, therefore, be loaned to customers. Furthermore, in many of these countries—and perhaps in the Russian Federation—there is a confusion about entitlements to capital in case of insolvency. In some countries, there is a concept that shareholders in financial difficulty can call for the return of their capital. The concept of capital, however, depends on the setting of priorities for repayment in case of bankruptcy, which, in turn, depends on the establishment of bankruptcy principles. Clearly, these principles have not yet been established in all countries.

Owners

The rules relating to the qualifications of owners of banks in all CIS countries are rudimentary. Sometimes, owners are required to prove their creditworthiness, which is perhaps based on an imprecise understanding of the legal separation between shareholders and a joint-stock company, and perhaps also on the above-mentioned idea that the capital of a joint-stock company in some sense belongs to the contributors. A common requirement is that the managers of the bank must be fit to hold their positions, but there is usually no similar requirement for the owners of the bank. Allegations that Russian banks are owned by unsuitable persons are numerous. Furthermore, many banks are owned by industrial companies that (especially in the absence of suitable controls on connected lending) may manage the banks for their own purposes.

Risk Recognition

The essence of Western prudential rules is to leave banks generally free to make their own lending decisions, but to take steps to recognize and limit risks. The following list compares the rules applicable to Western banks with the rules applicable to banks in the CIS:

- Western banks are commonly required to show that they have lending policies and procedures to evaluate the risks of lending and that they follow their own policies and procedures; there is no such requirement in the CIS.
- Western banks are often limited in their ability to engage in nonfinancial activities, either directly or through daughter companies. If they are allowed to engage in such activities, these may be strictly limited in volume. Comparably, the limitations in Russia and other CIS countries are ineffective. A bank may be prohibited from engaging in industrial activities directly, but it is entitled to own a company that engages in such activities. Also, a bank can be (and often is) owned by an industrial company.

- Banks in the West are often controlled in their ability to lend to persons connected with them, because lending decisions in such cases may not be rational (based on risk assessment and likely returns) but rather directed by the "parents." The rules that are imposed may be "arms-length" rules, as in the United Kingdom, a quantitative limit, as in the United States, a simple prohibition, or other means (such as capital penalties).[14] In the CIS, however, there are usually no special limits for connected persons, and, as a consequence, a large number of the banks lend most of their funds to their founders, which may be regional councils, insolvent state-owned enterprises, or even private enterprises.

- Western banks have imposed on them strict limits on the size of their exposures to particular borrowers, so that the failure of single persons will not cause banks to collapse. These limits must also apply to persons that are financially interlinked. In the CIS, the limits are set at levels that are quite high, and there are no rules applying to persons connected with one another, so that in effect the rules are worthless.

- Finally, Western banks are required to identify debts that are recognized to be nonperforming and to keep special internal reserves or "provisions" against such "bad debts." These provisions come either from profits or are deducted from capital. Such deductions will, in turn, affect banks' gearing ratios and lending ability. In most or all of the CIS countries, there are no such requirements. Clearly, given the difficult financial position of so many of the enterprises, the amounts of nonperforming loans are very high, but this is not shown on the books of the banks. Even though there is no legal requirement to identify bad debts, banks tend to disguise them from their supervisors in any case, either by rolling over the loans (extending their terms if borrowers cannot repay) or by adding unpaid interest to the principal amounts outstanding (capitalizing the assets and giving the impression of a healthily expanding balance sheet). The result is that the supposed capital base of the banks is largely illusory, although, admittedly, it is often very difficult to prove this in individual cases because of the lack of accounting skills and reliable accounts. It seems a reasonable conclusion, however, that, if banks in the CIS were subjected immediately to Western rules—and it is not suggested that they could be or should be—nearly all banks would be, in Western terms, bankrupt.

An additional problem that the banking systems in the CIS face is that the central banks lack sufficient staff, even (within Russia) taking all of the numerous branches into account, to supervise the commercial banks.

What regulatory staff members there are in the central banks are often overworked and have themselves been unable as yet to obtain full training in the techniques of banking supervision. Furthermore, as soon as staff members gain these skills, many are tempted away to commercial banks that can offer higher wages. Finally, there is evidence in some areas of either intimidation or corruption of some central bank staff.

Reforms

What measures might be taken to improve the situation?

Better Prudential Rules

All of the above matters will eventually have to be addressed—the sooner the better. In Russia, an experiment is being sponsored by some of the international organizations, called the International Standards Bank (ISB) program.[15] The idea of this program is that, because it is difficult to force banks to comply with prudential standards, these banks might instead be encouraged voluntarily to adopt higher standards.[16] In return for the accelerated introduction of banking standards closer to Western standards by a selected group of banks, these banks would be offered incentives reflecting the reduced risk that they posed to the system.[17] Implementation of such a program by some banks does not imply that over time all Russian banks will not have to move to higher standards. It is merely an attempt to produce more quickly a core of identifiable banks that will have—and will be recognized to have—higher standards.[18]

The World Bank has recommended that new bank licenses should be issued only to ISBs and that, meanwhile, licensing processes should be tightened and supervisory capacities strengthened.[19] To promote general competition in the banking sector, the World Bank also recommends a properly designed deposit insurance program, limited in coverage to small deposits.[20] (The premiums would be lower for ISBs than for other banks.)[21]

Substantial Recapitalization

It is clear that substantial recapitalization of the banking system, or at least that part of it that is identified for development, will be required.

New Banking Laws

New banking laws or clarifications of the old will be required.

Bank Closures

Bank closures will be inevitable (a number of licenses have now been revoked by the Central Bank of the Russian Federation). Such closures (or mergers) will be prompted by the capital increases already mentioned or by the effect of the bankruptcy law (discussed below) on many bank customers, which will force the banks to recognize the many defaulting loans. In particular, consideration must be devoted to Sberbank. There are two main options. First, it could be treated more like an ordinary commercial bank and allowed to lend freely to enterprises (it is presently controlled in this activity).[22] Because Sberbank takes most household deposits, this option would require most of the supervisory resources to be directed to it.[23] If this option is taken, it might also be desirable to sell off a number of the branches of Sberbank to other commercial banks, in order to reduce its effective monopoly on household deposits.[24] The second option is to continue Sberbank's role as the primary taker of household deposits and to prohibit it from lending to enterprises, and to restrict the size or conditions of its lending in the household and interbank market.[25] Its other deposits would then be used to purchase government bonds.[26] Sberbank could then perhaps retain the government guarantee of its liabilities.

Good Accounting Rules and Practices

Good accounting rules and practices need to be introduced as a matter of urgency, both to assess the creditworthiness of enterprises and to verify the state of the banks themselves.[27] The training needs here, as in other areas, are enormous.

Law of Collateral for Lending

A good law of collateral for lending, coupled with an adequate registration system, is required, so that banks can reduce the risks to themselves and their depositors and so that persons can use their property as a lever to obtain funding, thus freeing the economic potential inherent in property.[28] Property laws must also be changed to clarify ownership rights.[29] Without such a law of collateral, it will be particularly difficult to end the system of agricultural subsidies, as farmers will be unable to borrow freely from the banking system.

Bankruptcy Law

A good bankruptcy law is required.[30] Such a law will help to establish the conceptual framework for other legislation on businesses. Key con-

cepts, such as limited or unlimited liability, corporate personality, or even the definition of capital, can depend upon the provisions of the insolvency law. It may also be invoked as part of the privatization process in deciding whether to liquidate an enterprise on a breakup basis or on a going-concern basis, and it can be used in the restructuring of insolvent enterprises. It is necessary for the financial health of the banking system that banks (and other creditors) be able to recover some part of unpaid debts in a timely manner. A good bankruptcy law is also essential to spur the efficient management of enterprises and to assist in gaining fair treatment for lenders and other creditors. Its economic function is to enable assets that are not being put to profitable use to be recirculated and used efficiently. Finally, a good bankruptcy law can help to prevent certain abusive trading practices, such as continued trading when a company has no reasonable prospect of success or the granting of security when a company is insolvent.

Payment Systems

Laws for payment systems are required to deal with all the methods by which payments are made. These systems can be debit based (as with checks, bills of exchange, letters of credit, direct debits, and similar instruments); credit based (as with credit transfers, giro payments, and most electronic payments); or card based.[31] Each of these instruments of payment requires a clear legal basis, which is often missing at present (especially in the case of credit transfers).

Dispute Resolution Procedures

Dispute resolution procedures need to be improved. In particular, arbitration procedures, if backed by sound legislative rules, may help to assist where court procedures are slow, unskilled, expensive, or not objective.

Conclusion

The range of issues affecting banking laws in the former Soviet Union is large, and the foregoing discussion is merely a brief indication of some of them. The problems facing the banking system in the former Soviet Union are great and will take years to solve.

COMMENT

DEBORAH K. BURAND

This comment examines (i) the challenges facing the evolving banking system throughout the Baltic countries, Russia, and the other countries of the former Soviet Union, (ii) the rules that are being developed to respond to those challenges (the who, what, and where of banking laws and regulations), and (iii) the how of banking regulation, namely, How are these laws and rules going to be enforced?

Challenges Facing the Banking System

Early analysis of banking reform in the former Soviet Union tended to produce agreement about the challenge that was facing each of the countries. In 1992, the challenge often was described as the challenge of turning centrally administered, monopolistic banking systems that were insensitive to credit risk into competitive, efficient allocators of resources. That challenge remains in most countries of the former Soviet Union. Many of the banking systems within the former Soviet Union continue to be dominated by the direct successors of the old, state-owned Soviet banks. These banks often continue to have a monopolistic hold on sector-specific lending practices and are also characterized by large portfolios, uncollectible assets (sometimes so large that they give rise to a negative net worth), and a resistance to portfolio diversification.

Decentralization and fostering competition have presented many of the countries of the former Soviet Union with yet a new challenge: a proliferation of new banks. These new banks are attracted by low reserve requirements and anticipated profits. They are sometimes set up by state-owned enterprises, such as Aeroflot or the AvtoVAZ car company; sometimes, they are set up by private companies to attract deposits for relending to their owners. Consequently, a second generation of banking laws and regulations is being implemented in the countries of the former Soviet Union that responds to both of these challenges—the need to decentralize and encourage a competitive environment within the banking sector and the risks posed by a proliferation of new and often inexperienced entrants into the banking sector.

Responding to the Challenges

Turkmenistan presents an example of how this second generation of banking laws and regulations is evolving. This is certainly not to suggest that Turkmenistan has a banking law that can be used as a model or

one that is better than that of any other former Soviet republic. Turkmenistan's population is only 4.5 million. As a result, the banking needs of such a country will be vastly different from those of Russia or many of the other former republics. However, some of the issues that confronted the drafters of Turmenistan's commercial banking law are common to the issues confronting other former Soviet republics.

In May 1992, Turkmenistan enacted a commercial banking law.[1] In October 1993, a new commercial banking law was put into place in anticipation of the introduction of the country's new currency, the manat.[2]

Who Is Being Regulated?

Determining who should be regulated by the new commercial banking law is the first of these issues. In answering this question, three areas of Turkmenistan's commercial banking law are noteworthy: the banking law's definition of a commercial bank,[3] the application of the banking law, and the entry of new commercial banks.

First, with respect to the definition of a commercial bank, the drafters of Turkmenistan's new commercial banking law were faced with a balancing act. On the one hand, drafting an overly broad definition of the term "commercial bank" would strain Turkmenistan's limited supervisory and regulatory resources. On the other hand, an overly narrow definition would permit parties to conduct banking activities outside a commercial bank and thereby escape adequate supervision and regulation by Turkmen regulatory authorities. In the end, the Turkmen authorities chose a definition of a commercial bank that included only those institutions licensed to take deposits and perform other banking operations. Those "other banking operations" are enumerated in Article 13 of the new commercial banking law. Expressly excluded from those permitted banking activities is the provision of most types of insurance. Also, commercial banks in Turkmenistan are expressly prohibited from engaging in general commercial activities.

Second, with respect to the application of the commercial banking law, a goal in Turkmenistan was to level the playing field among banks, thereby fostering competition and breaking the concentration of sector-specific lending practices of some banks. Before the new banking law was put into place, banks had individual charters. The bank powers granted in those charters varied from bank to bank. Serious consideration was given to requiring existing banks to return those charters and to be relicensed under the new banking law, with a view to leveling the playing field for all banks. However, there was strong resistance from some of the former (and continued) state-owned banks, with the result that such a requirement was

not included in the new commercial banking law. It is not surprising that existing banks would resist the introduction of a new regulatory scheme that would prevent them from conducting the kinds of activities and enjoying the kinds of privileges to which they have grown accustomed. On a going-forward basis, the commercial banking law enacted in Turkmenistan has taken steps toward setting forth a more level playing field for *new* banking establishments in Turkmenistan. It is less clear whether the new commercial banking law also has leveled the playing field for pre-existing banks—like the savings bank and the bank on foreign economic activity, which argued strenuously during the negotiation of the new commercial banking law that they should be allowed to be regulated by both their old charters and the new banking law, and, in the event of any inconsistencies, that their individual charters should govern.

Third, before enactment of the 1993 commercial banking law, the requirements for entry for those wanting to set up a bank in Turkmenistan were quite liberal, the application process for establishing a bank was murky, and the regulations governing these applications were ambiguous. Prospective banks were encouraged to concentrate their lending portfolios and were required to demonstrate to the Central Bank that they would meet the demands of a particular sector or client base. Also, there was a bias in Turkmenistan favoring all prospective entrants into the banking system.

This bias continues even today in the application process. For example, the new commercial banking law requires the Central Bank of Turkmenistan to pay financial penalties to bank applicants if it does not act on their applications within the time limits set forth in the commercial banking law.[4]

However, as the new banking law was being developed, the Turkmen authorities decided to impose a freeze on the licensing of new applicants in order to give Turkmen authorities time for a more careful consideration of the barriers of entry needed in the banking system and of the types of information required of the applicants. Although the commercial banking law that went into effect in 1993 has no defined grounds for refusing a bank license, it is to be hoped that the evolving system will become more transparent. One step in this direction is the requirement in the new commercial banking law that the Central Bank explain to rejected applicants its grounds for rejecting their applications.[5]

What Is Being Regulated?

Determining the scope of activities to regulate raises several issues, including how far to broaden the scope of permitted banking activities

and how quickly to permit banks to take advantage of such expanded banking activites. An important consideration in determining the speed of change and the scope of change was a concern that the skills of both the commercial bank staff and the bank regulators should not be outpaced. Turkmenistan has not opted for a universal banking scheme; its banking law, however, does enumerate permissible banking activities that are similar to those found in the Russian banking law.[6]

Where Are Banks Regulated?

Where banks are regulated is an issue of growing importance in a world in which host countries increasingly look to comprehensive consolidated supervision by the home country before permitting a foreign bank to establish a banking presence. Turkmenistan's commercial banking law permits Turkmen banks to open branches and offices outside Turkmenistan.[7] Turkmenistan will apparently require reporting from those banks on a consolidated basis. How that will actually happen is uncertain, in part because of the accounting standards that are used in Turkmenistan. Moreover, the Central Bank's authority to inspect and examine offices of Turkmen banks located outside Turkmenistan is unclear.

The "How" of Bank Regulation and Supervision

Once the commercial banking law—the skeleton on which bank regulations hang—is in place, the question becomes, What kind of regulations are going to be developed to implement the law? In Turkmenistan, the regulatory scheme that will be built around the new commercial banking law is not entirely clear. Regulations were being drafted as the new law was being put into place. Typically, there have been few chances for public comment on banking regulations, particularly for prospective bank applicants to look at the rules and regulations that could apply to them. Past practice in Turkmenistan has been to make banking regulations available only to those already in the banking business.

In Turkmenistan, both the reporting requirements and the supervisory authority of the Central Bank have been strengthened. The sanctions that the central bank authorities can impose upon banks provide varied means to address problem banks, including imposing fines, convening meetings of shareholders, removing management from the banks, and revoking banking licenses.

What type of incentives can be put in place to encourage compliance with the banking law? Besides market forces, which are a strong and useful tool for encouraging compliance, one tool often used elsewhere and

likely to be seen in Turkmenistan is to allow banks that are strongly capitalized a greater scope for banking activity (within the statutory limits of what can be conducted as banking in Turkmenistan) than banks that are weakly capitalized.

Chapter

16 Banking Law Reform in China

TOBIAS M.C. ASSER

Introduction

It was in the fall of 1992 that China decided to change its command economy to what is called a socialist market economy. Although the Chinese authorities are still in the process of giving content and definition to the term "socialist market economy," this much is known: China's economic system will be unique, as it will reflect the unique social, political, and cultural traditions of China's vast and diversified population.

In the fall of 1992, the Chinese authorities also requested the IMF to provide assistance to the People's Bank of China in drafting new central bank and banking legislation that would provide the necessary institutional and regulatory support for China's banking sector in a socialist market economy. In response to this request, staff of the Legal Department and the Monetary and Exchange Affairs Department of the IMF embarked on an intensive legislative assistance program.

As part of this program, the People's Bank of China was given detailed memoranda prepared by IMF staff that discussed some of the principal issues that had to be considered with respect to the proposed central bank and banking reform program, a collection of central bank and banking legislation of representative countries around the world, and illustrative models of provisions that should be included in China's new legislation. This assistance program culminated in a joint workshop that was given in Beijing in September 1993 by managers of the People's Bank of China and senior staff of the IMF and several European central banks; the workshop was attended by high-level officials of China's State Council and People's Congress, and by representatives of China's banking community. Since then, China's leadership has been engaged in extensive discussions concerning the principal characteristics of the new central bank and banking system that must be reflected in the new legislation.

As far as is known, no definitive decisions have yet been taken in China concerning its banking reform. Therefore, this discussion of banking law developments in China must be somewhat tentative and remain incomplete. It is possible, nevertheless, to sketch an outline of some of the dif-

ficult issues that must be addressed by China in adapting its banking sector to a market economy environment.

Among these are some fundamental issues that go to the heart of the financial system: the role of the People's Bank of China as guardian of the value of the national currency and as regulator of the banking system; and the financial and operational independence of commercial banks in a market economy, including freedom of contract.

Law Reform in China

Before these topics are addressed in greater detail, however, some general comments should be made about the task of law reform in a society that is in transition from a command economy to a market economy.

To be successful, the transition from a command economy to a market-based economy requires not only changes in economic thinking but equally changes in legal thinking. In fact, the changes in legal thinking that are required are nothing short of revolutionary, mainly because there is a fundamental difference between the function of law in a command economy and the function of law in a market economy. Whereas in a market economy the law governs economic agents and their transactions, the law in a command economic setting is an instrument of power designed to serve the interests of the principal economic agent, the state.

This functional difference of the law is particularly significant with respect to the economic activities of enterprises. In a command economy, the law is designed to preserve the freedom of the state only, and individual enterprises generally lack the freedom of economic decision making or freedom of contract that is one of the hallmarks of a market-based economy.

In a command economy, the principal function of economic law, such as banking law, is to regulate the manner in which state enterprises conduct their day-to-day business. This function is not only justified but also unavoidable because in a command economy state enterprises are instruments of the state that are bound to carry out their designated tasks under a state plan. In a command economy, state enterprises have no true independence and little freedom of economic decision making as most decisions are taken by the central government under the plan. The negotiation of contract conditions governing the supply of goods or services to or from other economic agents is mostly ritualistic and has little economic significance because most of these conditions are carefully controlled by the state.

In a market-based economy, there is no state plan. Even if enterprises are owned by the state, they are responsible for their own economic decisions in an environment where prices are determined not by the state but by the market. Contracts with other economic agents are freely entered into at conditions negotiated between the parties. As a market economy cannot function without this freedom of economic decision making, the law functions to support and preserve this freedom.

For these reasons, the functions of banks and, consequently, of banking law in a command economy differ fundamentally from the functions of banks and banking law in a market economy.

In a command economy, banking law is mainly prescriptive and regulatory. Its principal objective is to establish precise and detailed rules and procedures that direct and control the operations of banking institutions, which are mostly those of cashiers under the state plan. In a command economy, banks are governmental organizations; they are organs of the state. Therefore, banking law is mainly administrative law written to instruct banks how to conduct their day-to-day business.

In a market economy, however, banks are autonomous economic agents that are independent of the state. In principle, the state has no authority to direct their activities. In a market economy, the principal function of banking law is not to instruct banks how to conduct their business but rather to ensure that banks will avoid inappropriate activities that would endanger the financial system as a whole.

Thus, in short, whereas banking law in a command economy tells banks how to conduct their operations, banking law in a market economy tells banks only how not to conduct their operations. Whereas in a command economy banking law covers the entire spectrum of banking activities, in a market economy banking law only operates at the margin to provide a legal framework within which banks may conduct their business in freedom.

The principal reason for this functional difference between banking laws in these two economic systems must be found in the fundamental difference between these systems in the freedom that they accord to individual economic agents—such as banks—in their economic decision making. Whereas this freedom of economic decision making by individual enterprises is severely restricted in a command economy, freedom of economic decision making is one of the cornerstones on which a market-oriented economy rests.

It is one of the basic functions of the law in a market economy to support and preserve this freedom of individuals to enter into contractual relationships. This principle of freedom of contract has several important

consequences for the content and application of the law, in particular banking law. During the mission of the IMF in China, these consequences were discussed at length with officials of the People's Bank of China.

For China, one of these consequences is that the People's Bank of China as bank regulator and the commercial banks must each have juridical personality and full operational independence under the law. Another consequence is that market-oriented banking law must operate not at the center of banking activities but at the margin of banking activities. At the center, there is freedom of economic decision making and, perforce, freedom of contract. Therefore, in order to respect such freedom of contract, a good deal of restraint must be exercised in writing and enforcing banking law and the prudential regulations that are issued under its authority.

Reform of China's Financial Sector

Currently, the monetary policy of China is formulated, adopted, and executed by the State Council. As far as we know, no definitive decision has been taken by China's leadership to change this.

The staff of the IMF has advised China that experience gained around the world teaches that, to be successful in a market economic setting, monetary policy should be entrusted to an autonomous central bank that is largely independent of the political establishment. However, the time may not yet be ripe for such a drastic transfer of power to the People's Bank of China. It should be remembered that, in a command economy, the very idea of a governmental agency that is independent of the state is pure heresy and entirely irreconcilable with the structure of a corporate state. It is quite possible, therefore, that China will adopt a model whereby only the execution of monetary policy will be entrusted to the People's Bank of China, while monetary policy will be formulated and adopted either by the State Council or by a monetary council that would be positioned between the State Council and the People's Bank of China.

It was decided in principle that the People's Bank of China would have as its primary objective to achieve and to maintain the stability of the national currency and that this objective would be enshrined in the central bank law.

This decision evoked the question of whether the People's Bank of China could continue to exist as a kind of government department or whether the People's Bank of China should be established by law as a legally independent entity endowed with adequate capital resources. It was agreed that, if the People's Bank of China would lack legal independence, it would lack the operational and financial independence that it

would need to execute efficiently its tasks in the areas of monetary and foreign exchange policy and its duties as bank regulator. For example, the People's Bank of China would carry out monetary policy through the use of monetary policy instruments such as open market operations, which would require the People's Bank of China to buy and sell in the markets government securities for its own account. Although it would be theoretically possible for the People's Bank of China to do this as a legal extension of the state, such financial operations would have to be carried on the state budget, which, to say the least, would be inefficient. Therefore, it was decided to establish the People's Bank of China as a juridical person that would be legally independent of the state.

The most important argument supporting legal independence for the People's Bank of China is that without such independence it would be impossible to establish the People's Bank of China as a central bank with sufficient autonomy to carry out its primary objective of achieving and maintaining the stability of the value of the national currency.

China has decided in principle that the licensing and supervision of all depository credit institutions will be entrusted to the People's Bank of China and its vast network of provincial and local branch offices. This decision will ensure that the regulatory standards that will apply to individual classes of banks will be the same throughout China. Thus, China will ensure a level playing field on which all banks that belong to the same category will be subject to the same regulatory cost base.

It must be expected that the institutions to be regulated by the People's Bank of China will include the four specialized banks, such as the Bank of China. All four banks were chartered and supervised directly by the State Council. As these banks are large and powerful, one of the questions that remains to be resolved is whether special steps must be taken to bring them under the regulatory control of the People's Bank of China, for instance, by replacing their charters with licenses issued by the People's Bank of China.

Legal and Operational Independence of Banks in China

In order to exercise freedom of contract in China's new socialist market economy, the banks in China must be independent entities under the law. In contrast with banks in command economies, banks in market economies must be truly independent of the state. The Chinese authorities realize that, if banks would lack such independence or autonomy, they would not be able to exercise the freedom of economic decision making that is required for the efficient execution of their important tasks in China's growing socialist market economy.

The autonomy of banks does not necessarily depend on their ownership. In several countries, independent commercial banks are owned by the state. France is a notable example; however, French state ownership of commercial banks has not diminished their autonomy of economic decision making or their freedom of contract.

Banks must be granted adequate operational autonomy and independence from their respective owners. For a state-owned bank, this requirement concerns the manner in which the bank conducts its business—whether as an extension of the government or as an autonomous commercial entity. To ensure such autonomy for state banks, it may be necessary to reorganize them and to give them a commercial legal personality and corporate structure. China appears to be firmly committed to a program of law and policy reform that will ensure legal and operational independence under the law and full protection from the law for all banks, regardless of ownership.

However, establishing independence by law for the commercial banks, and even for the People's Bank of China, will not be sufficient in and of itself. More than the law, the command economic practices must change in China. There are several examples of countries in transition from a planned economy to a market economy where law reform remained largely without its intended effect because it was not accompanied by a corresponding change in the command structure of the government. Legal independence of the People's Bank of China (and the commercial banks) can be meaningful only if the state (and the People's Bank of China as bank regulator) respects such independence as true operational independence, as independence of decision making. Obviously, such independence can be successfully maintained only if the central bank is accountable to the state for its decisions. These fundamental and, therefore, difficult changes in attitude and behavior cannot be expected to be made overnight in China.

Policy Reforms in China's Banking Sector

Policy reform may be the most problematic area of reform of China's banking sector. More than the other areas of reform, policy reform requires a change of thinking, a change of attitude. This is especially true for the government. Whereas in a command economy the government exercised control over the national economy, this control must now be relinquished and transferred to an ill-defined and highly unpredictable entity known as the markets. Making this change requires a great deal of resolve, strength, and courage. All governments—whether in command or market-based economies—have an instinctive dislike for relinquishing power. The recent spate of deregulations in industrialized countries and

the gut-wrenching decisions that were required of politicians and bureaucrats alike may serve to illustrate this tendency.

Banking supervision is one of the areas where a command economy differs significantly from a market economy. In a command economy, banking supervision consists mainly of ex post control of the implementation of the state's credit plan. In a market economy, however, banking supervision concerns the soundness of banks and thus the compliance with prudential standards that are designed to regulate and limit the risks that banks may be exposed to—and the risks that the financial system as a whole may be exposed to through the banks. In a market economy, banking supervision involves not only ex post but especially also ex ante supervision.

One of the areas where policy reform is urgently needed in China is the practice known as policy-based lending. Policy-based lending is a euphemism for bank loans to persons or on terms that would not be made available to such persons or on such terms if the bank making the loans had not been so instructed by a government official or politician.

In China, the practice of policy-based lending is pervasive. As one of the participants in the IMF's workshop in Beijing said: "In the banking system of China, one acquaintance is often worth more than ten tjaps." The era of "everyone eating out of one big rice bowl" cannot be brought to a close before a strict separation is made between commercial banking and government-inspired banking at all levels of governmental and commercial activity. Only when this separation is achieved can banks, and especially state banks, be truly independent and responsible for their own profits and losses.

The issue of policy-based lending by specialized banks and commercial banks is complex. One of the guiding principles must be that in a market-based financial system ***all*** bank lending, including policy-based lending, should be subject to market-oriented prudential standards. Loans to uncreditworthy borrowers or on terms and conditions that are significantly more favorable than sound banking practices dictate should by definition be regarded as inconsistent with the reasonable prudential standards imposed under the banking law. Such loans should, therefore, not be made by banks for their own account unless they are entirely funded or guaranteed by the central or local government.

This judgment does not imply that all concessional lending should be discontinued. Most industrialized countries have governmental loan and loan guarantee programs (for example, for agriculture, small business development, or export financing) that are carried out through the banking system; these could serve as models to be considered. Such programs,

however, are normally authorized by special legislation apart from the banking law. Accordingly, China has decided to establish several non-commercial banking agencies through which policy-based loans would be channeled in the future.

Although much policy-based lending could be transferred to a governmental institution, such as, for instance, an industrial bank or an agricultural development bank, several remaining loan categories would be more difficult to transfer out of the present banking system. The most problematic of these—and this may expose the heart of the problem—are the loans made at the suggestion or request of officials at various levels of government to finance expenditures that should be financed from budgetary resources (or should perhaps not be financed at all).

The foregoing considerations have implications for the banking law of China and the introduction of its prudential requirements. For instance, as banking law normally includes provisions governing lending operations of banks, one group of issues to be addressed is how existing policy-based loans should be treated on the balance sheets of banks: should these loans be transferred to the state or to one or more state development banks, or should they be covered by explicit state guarantees or by government bonds issued to the banks?

Related Reforms Required for China's Banking Sector

There is no question that great strides have already been made by China in transforming and developing its legal system into one that is suitable to support a socialist market economy. It is also true, however, that much remains to be done, not only in the area of legislation but also and especially in the areas of the administration of justice and legal education.

During the past decade or so, China has been blessed with explosive economic growth. The legal and institutional reforms that are required to support this development have lagged behind, however. In several areas of economic activity, in particular in the financial sector, this lag has led to what may be called legislative self-help at the provincial level. The result has been a diversity of provincial regulations and decrees that, although justifiable as emergency measures, should soon be harmonized and incorporated into one national legal system. Uniformity of law is a desirable objective not only from a legal standpoint but also and especially from an economic standpoint. Differences in law create uncertainties as to the content of the law.

Banking sector reforms may begin with law reform but they cannot end there. Without corresponding institutional reforms and extensive training

of bank regulators and external accountants, as well as of commercial bank personnel, banking reform cannot be completed. The same applies in China.

But it is perhaps even more important that banking law is by no means the only law that governs banks and their operations. For a sound banking system, more law than just a banking law and more institutional infrastructure than just a bank regulator are required.

Thus, China will need a market-oriented company law, which is under preparation. China will need a sophisticated property law and law of obligations that meet the needs of a sophisticated financial sector. China's banks will prefer to have their loans secured by collateral; this may require a system of registration of mortgages and other collateral rights. China's banks will need to have the means to enforce their contractual rights under loans through a competent and impartial judiciary and appropriate enforcement procedures set forth in a comprehensive law of civil procedure. China's banks will require a proper bankruptcy law that will permit them to pursue their claims against insolvent debtors. China's banks and its regulators will require the assistance of a qualified and experienced accounting profession to help establish and maintain for the banks effective accounting control mechanisms that enable bank managers to monitor constantly their risk exposure on a consolidated basis.

As long as these laws and legal institutions are not available, the transition to a market-based banking sector cannot be completed. A market economy cannot function efficiently without a well-developed legal system. In a market-based economy, lack of law tends to create uncertainties among market participants concerning their respective rights and obligations under market transactions. Such uncertainties will constrain market activity or will lead to higher prices because suppliers will seek to reduce their risks by increasing the prices that they charge for goods and services.

This entire process of law reform should be planned and executed in an orderly fashion. This means, in particular, that new legislation should not become effective before the administrative infrastructure required for its enforcement has been put into place. Law that cannot be enforced is worse than no law at all because it tends to diminish public respect for the law in general.

However, especially in the area of bank regulation, law enforcement is no panacea. It is impossible to maintain a sound banking system unless the large majority of banks voluntarily comply with the prudential rules issued by the bank regulator. The savings and loan crisis in the United States and, to some extent, the scandal involving the Bank of Credit and Commerce International in the United Kingdom demonstrate that our

bank regulatory structures and even our external auditing procedures cannot be relied upon to discover intentional fraud by bankers in time to avoid major damage to the banking system as a whole. China's bankers should be convinced that strict compliance with sound banking principles is in their own best interest as it helps build public confidence in the banking system. Confidence of the public is easier lost than gained. It is a fact of financial life that public distrust of some banks increases the cost of banking for all banks.

In many of these areas, China has a long road ahead of it. The restrictive practices of the past appear to have given way to often-unbridled freedom. China's bank regulatory system is still in its infancy and cannot develop further without effective banking laws and regulations. China's bank regulators have not yet been adequately trained in the unusual ways of a market-based banking system. Both market-oriented legislation and training are urgently needed. Nearly a year has passed since draft central bank and banking legislation was submitted to the State Council. China's bank regulatory system is overwhelmed by the explosive growth of new and often improperly licensed financial institutions. In the absence of appropriate banking legislation, the Chinese authorities are courting disaster.

However, there is another, more hopeful side to this story. The strong social and cultural fabric of China, the impressive energy of its peoples, and its age-old wisdom will help it overcome the inevitable problems that will present themselves during the difficult period of China's rapid transition toward a socialist market economy.

[Editor's Note: Following the presentation in May 1994 of this chapter, China adopted (i) Law of the People's Republic of China on the People's Bank of China (March 18, 1995); and (ii) Commercial Bank Law of the People's Republic of China (May 10, 1995).]

COMMENT

NATALIE G. LICHTENSTEIN

Current Developments in the Legal System of China

It has been recognized for some time that China's accelerating transition to a market economy requires corresponding changes in the legal framework for economic activity. The laws and regulations that were already in force cover economic activity in many ways. However, China's lawmakers and policymakers, as well as its enterprise managers and workers, all recognize that more laws and regulations are needed; many also recognize that more attention to the implementation and enforcement of these laws is essential if they are to achieve their desired ends.

Changes in the legal framework cover a wide range of areas. This comment focuses on a few of the principal ones evident by 1994.

Property Ownership

In recent years, a multiplicity of ownership forms has grown out of the reform experiments in China. No longer are the convenient categories provided by the Constitution (ownership by the whole people, collective ownership, or individual ownership) either sufficient or mutually exclusive.[1] For example, issues may arise concerning the ownership form of a company with state and individual shares or the real ownership of a collective enterprise. To give meaning to property ownership, the rights and obligations of ownership must be defined and enforceable, whether different owners of adjacent real property or several owners of intangible property (a shareholding company, for example, or a security) are involved. In many civil law systems such as China's, the basic distinctions among types of ownership and the provisions for acquisition, transfer, and disposal of ownership rights would be found in either the civil code or a law on property or ownership. Save for a few provisions found in the General Principles of the Civil Code,[2] enacted in 1986, China has neither.

Structure and Governance of Economic Entities

Reforms have also brought new forms of entities beyond the categories of state enterprise, collective enterprise, and individual household, which might have sufficed in an earlier time. Joint-stock companies have mushroomed, but only an interim set of directives gave them legal life until July 1994, when the Company Law entered into effect.[3] Even under the

Company Law, attention needs to be paid to the conversion process. Township and village enterprises are often described as a major factor in China's economic growth, but establishment of their legal structure awaits a new law. The leasing of small state enterprises to private operators requires clarity as to the legal rights and obligations of owner and operator. And the list goes on.

Commercial Transactions

Increasing reliance on market-based transactions between independent contracting parties requires a functioning system of commercial law. This system includes contract law and intellectual property law, as well as rules for commercial transactions. An adequate mechanism for enforcing commercial rights and obligations is a necessity, whether through a general or specialized court system or arbitration mechanisms, or a combination of both. While the Economic Contract Law was revised in 1993,[4] unification of this law, the foreign economic contract law, the technology transfer contract, and contractual rules for individuals are on the national legislative agenda. Intellectual property rights are now subject to a comprehensive legal regime,[5] but enforceability is the next frontier. Beyond contractual provisions, general rules for commercial transactions also lack the comprehensive treatment that a commercial code would offer.

Promoting a Competitive Market

Promoting fair and effective competition among autonomous enterprises is a cornerstone of the market economy. At the same time, there is a public interest in protecting against anticompetitive behavior that harms consumers through higher prices or lack of products and, equally, in protecting against harmful or shoddy goods in the marketplace. Competition law has a new beginning in China with the recent enactment of the Anti-Unfair Competition Law,[6] but more will need to be done to establish antimonopoly provisions and effective enforcement mechanisms. Protection and promotion of competition is especially important in a transition economy such as China's, where governmental barriers to trade need to be dismantled while the permissible bounds for enterprises' competitive behavior are still being defined. Consumer protection, too, has been the subject of several legislative actions in 1993. The Consumer Protection Law passed in the fall of 1993.[7]

Another aspect of bringing market competition to enterprises is the pressure of market exit, for which bankruptcy law provides a framework. China's bankruptcy law applies only to state enterprises,[8] while other enterprises may be put into bankruptcy under the provisions of the Civil

Procedure Law.[9] A more comprehensive, market-oriented framework for bankruptcy, regardless of ownership, is needed to bring order into the insolvency process and, especially for state enterprises, to bring the threat of forced exit more fully into play. China's legislative officials are contemplating revising the bankruptcy law along these lines.

Market Access to Resources

Specialized legal provisions are necessary for the operation and regulation of markets in capital, land, and labor. Capital market legislation in China has made a start, with local legislation introduced earlier in Shanghai and Shenzhen followed in 1994 by nationwide regulations on the issuance and administration of shares, as well as by market regulation.[10] Still, a nationwide securities law remains a legislative goal, and the banking and financial systems necessary to underpin the capital markets are at early stages of development, as both central banking and commercial banking laws have only recently been enacted.[11] Land markets are booming, based on national legislation and supplemented by local legislation detailing land-use rights and their administration, transfer, and ownership. Concern over fragmentation and potential speculation in land markets has prompted calls for a nationwide real estate law, which would give a more substantial and consistent basis for land market transactions. Labor markets are also at an early stage, and their development will depend, in part, on the ability to provide social welfare benefits (health, unemployment, and pension) separately from employment. In this area, too, legislation is in an early phase.

Enforcement and Dispute Resolution

Perhaps one of the most striking changes in legal behavior from a planned economy to a market-based one is the reliance on legal instruments in lieu of government directives to enforce rules and resolve disputes. Economic actors must believe that they will be held to their legal obligations, and that their legal rights can be given meaning through legal protection. Government regulators, who should no longer command enterprises or individuals to make economic decisions, must have the ability to use administrative sanctions and to resort to courts, whether in protecting the environment or the sanctity of the market, when those economic decisions fall afoul of the new legal rules. Moreover, this behavioral change should be accompanied by a strengthening of the expertise and independence of the dispute resolution systems, whether mediation, arbitration, or litigation. Some structural experiments are under way, such as the specialized intellectual property court in Beijing and in other

provinces. The training of judges and court personnel in economic subjects is also an important aspect of this judicial strengthening.

From this silhouette of China's economic laws, it can be seen that much progress has been made, although a wide range of subjects remains to be more fully treated in the formal legal structure, such as property law, securities law, and bankruptcy law. Beyond the specific areas of law in which further developments are necessary and anticipated, however, some elements of the legal reform process in China also deserve attention. Two key elements are the process of preparing and enacting legislation, and the legal education and training needed to ensure implementation of the new legal framework.

Legislative Process

Judged by output alone, the legislative process in China in recent years has been increasingly active. All levels of the process—the preparation of laws at the line ministry stage, the review among agencies under the aegis of the State Council, the revision and discussion at the State Council or the National People's Congress or its Standing Committee—have important functions, and all levels have been shouldering and will continue to shoulder a heavy burden of legislative work related to the market economy. While it will be important to strengthen the number and training of the legal personnel in these agencies to keep up with this burden, there are some other concerns that, if not abated, could slow the process.

Automatic Resort to Law and the Problem of Fragmentation

Each central ministry department typically has a list of laws that it feels are urgently needed, and that it is uniquely qualified to draft. While each of these proposed laws may address a problem in the economic transition (for example, investment law, planning law, public funds law, or antimonopoly law), not all of these are problems that require a law to solve. Often, several different agencies may claim exclusive responsibility for drafting the same law. Even where laws are necessary, it is not always clear that separate laws are needed for each area; sometimes, different agencies are discussing subjects that would be better treated as chapters of the same law than as separate laws. Treating related topics in one law often brings the advantages of consistent standards, consistent application by the same enforcement agency, and ease of future revision.

Uneven Progress

To the outside observer, it sometimes appears that China's legislative progress has been uneven. For example, some fairly sophisticated securi-

ties regulation topics are being addressed, such as standards for the staff of the securities regulatory commission, but a nationwide securities law has yet to be enacted (although one is in preparation). Joint-stock companies are all over China, many with shares traded on the exchanges at Shanghai and Shenzhen; yet, until July 1994, only Shanghai, Shenzhen, and Guangdong had company legislation, and the national legislation consisted of agency directives rather than State Council regulations. There are still gaps in the basic foundations in a few places (such as property law), while the towers and parapets are being put into place in other parts of the legal structure. Some of this uneven progress is quite normal, but what is important is to ensure that parapets are not added where the foundations are weak. Tensions have also arisen because some subjects are more fully treated in local legislation than national legislation because of either the absence or the vagueness of national legislation.

Departmentalism

The bulk (about 80 percent, by some estimates) of the laws eventually enacted by the National People's Congress (NPC) or its Standing Committee are prepared under State Council auspices, that is, by the departments and agencies under the State Council. The balance are prepared initially at the NPC level. Some observers have suggested that, where a line ministry is primarily responsible for considering policy content, preparing initial drafts, and organizing other agencies in drafting groups, it is most likely to act in its institutional self-interest. That behavior may not always be in the overall interest of the public, and it becomes difficult for higher-level reviewers (such as the State Council or NPC) to counteract these tendencies once the draft law is at an advanced stage.

These departments' lawyers, however, often have been exposed to the detailed rules and functioning of other market economies in their specific sector, so that their knowledge of the subject matter may turn out to be deeper than the reviewers'. One goal of technical assistance would be to deepen the comparative knowledge of specific legislative topics in the core reviewing bodies.

Access to Foreign Experience and Comparative Laws

Many legislative drafters have expressed interest in having access to foreign laws and experiences as they prepare economic laws. However, it is not always easy to provide this access in a timely and meaningful way. Also, different kinds of experiences are useful for different laws at different stages. Early in the drafting process, it is useful to consult other countries' laws (in translation, if possible) and comparative law experts, in

order to see different systems and decide which, if any, are most suited to China's circumstances. Later, as drafters encounter difficulties in adapting or resolving issues in specific areas, more specialized expertise in the actual implementation of foreign laws may be of use.

While improving access is important, two caveats are needed. First, foreign laws and lawmaking processes can offer negative examples as well as positive ones—and both are helpful. Second, some officials may expect that access to foreign texts will speed up China's drafting because appropriate provisions can be copied. Experience elsewhere shows that this is rarely the case, because provisions cannot usually be copied without making significant changes to account for the difference in legal and economic systems. The benefit of foreign experience lies more in seeing the types of problems that require legislative solutions in a market system and evaluating the potential of these solutions for China.

Naturally, the type of laws at issue will affect the relevance of other countries' laws. In an area such as financial transactions, the rules for documentation and liabilities in the event of fraud would need less adaptation to reflect local conditions and traditions than would rules for property law where culture and ideology are key. It is also important in this process to remain aware of China's civil law traditions and the areas in which common law examples must be adapted.

Implementation of the New Legal Framework

It was previously suggested that enactment of laws and regulations to provide the rights, obligations, and procedures appropriate for the operation of a market economy is necessary for the development of a full-fledged market economy in China. However, enactment of legislation alone is not sufficient to bring about economic changes. It is also essential that these laws be implemented, in order to give a concrete reality to the legal rights, obligations, and procedures that the laws prescribe. A number of concerns about implementation are receiving and should continue to receive increasing attention as part of the reform process.

Training a Cadre of Lawyers

Chinese officials, including the Minister of Justice, have been commenting of late on the need to develop a cadre of lawyers to implement the new laws. This drive will have to surmount a number of problems, including lawyers who have legal training that is impractical or out of date; lawyers who have not received formal legal training; and government legal personnel who do not have adequate training in the special-

ized areas that they administer. A multifaceted approach will be needed to address these problems. Formal and informal general legal training should be given to those already in the profession who lack it. Also, training packages should be designed for wide application to educate lawyers, government officials, and business people about the rights and obligations under the newly enacted laws.

Renovating Legal Education

The flood of new legislation and new topics legislated will have an obvious impact on the legal education curriculum in the formal educational structure, as well as on the less formal (nondegree) training referred to above. Moreover, China's legal education sector will also have to adapt not only to changes in the laws that are taught, but also to changes in the legal profession. As more graduates become practitioners, for instance, they will need greater clinical training in lawyering. This general need for reform comes at a time when it is increasingly difficult to retain professors and to attract graduates into teaching, as the opportunities for careers practicing law are increasingly attractive, both professionally and financially. (This attraction of what is called elsewhere "the private practice of law" is an essential element of market behavior, but it has also affected the ability of government legal departments to retain experienced staff. Of course, neither phenomenon is limited to China.)

Strengthening the Court System

The need for judges and court personnel to have access to training in the new laws and the fields of economic activity that they seek to regulate was noted above. In addition to the need for training, at least two other aspects of the judicial system are essential to consider. Can it handle the increased load, or will additional personnel be needed (and where will these new judges come from if private practice is so attractive)? Is the system perceived as fair, both in adjudicating between parties to a particular dispute and in general?

Behavioral Changes

The legal skills needed to implement laws in a market economy are also somewhat different. Transactional lawyers need to be able to identify and resolve practical issues, mindful of their client's business interest; advocacy skills are also important in the dispute resolution process. Focusing some training efforts in this area will be increasingly important. Moreover, there is a need to develop a code of ethics for the legal profession. Conflict-of-interest issues and the appearance of impropriety are

but two types of constraints on lawyers' behavior elsewhere that have relevance for China. To what extent can lawyers handle cases for competing clients? What are the sanctions for revealing confidential information? These are the kinds of issues that, in the U.S. system, for example, the lawyers' association has addressed in a code of professional responsibility.[12] Law students are required to study it, and lawyers are bound to uphold it. As China faces increasing concerns over corruption in the economy, the need for these kinds of ethical norms becomes apparent—both for lawyers and others.

Conclusion

These remarks highlight some of the problems that the passage and implementation of banking laws in China (noted in the preceding chapter) are likely to face in the coming years. Debates and differences may complicate the legislative process, although a more open process may lead to a result reflecting a wider variety of viewpoints. Lack of experience with corporate structures is likely to affect the "corporatization" of commercial banks, and the development of commercial laws is likely to affect these banks' commercialization. Also, regional differences could easily affect the implementation of central supervisory responsibilities.

[Author's Note: This comment was presented in 1994 and does not reflect fully the passage of numerous economic laws in China since that time, such as the banking law, central banking law, labor law, and guarantee law.]

Chapter 17 Banking Supervision Around the World

17A. The Role of the Central Bank

LARRY PROMISEL

This chapter addresses the general issues associated with the role of the central bank in bank supervision and regulation and the question of why it is important that central banks should be involved in these matters. Chapter 17B addresses how bank supervision and regulation are implemented and practiced in the Group of Seven countries.

Maintaining Monetary and Financial System Stability

It is the fundamental responsibility of central banks to ensure monetary stability and the stability of financial markets. Each central bank has a somewhat different mandate and objectives; broadly speaking, however, these two objectives apply to all central banks. The two aspects of this responsibility are also distinct, that is, one can talk about what it takes to ensure monetary stability separately from financial market stability. The distinction to be made is between (i) monetary stability, which involves stabilizing the price level and the value of the currency (essentially a macroeconomic set of issues), and (ii) the stability of financial markets, which has to do more with the institutions in the financial sector, the players, the structure and infrastructure of the financial markets, and financial market prices. These two areas are obviously closely related.

In order to implement the two objectives, central banks conduct a range of functions, one of which is (or certainly could be) banking supervision and regulation. That function clearly has a direct impact on financial market stability. The focus in this chapter is on the indirect aspects of the supervisory or regulatory role of central banks, namely, how that function interrelates with or reinforces the other central bank functions.

One central bank function is the monetary policy function itself. In order to carry out a reasonable monetary policy, central banks need to understand its transmission mechanism, that is, how a change in the instruments of monetary policy affects the economy and its various components. While the structure of financial markets varies from country to country, the transmission mechanism in all countries is likely to involve

banks. Therefore, it is important in conducting monetary policy to have as full an appreciation of how banks operate as possible. From the point of view of monetary policy, the central bank does not have to play a supervisory role. Even without access to examination reports, one can learn how banks operate. However, it is helpful and has been important in the United States for the central bank to play a supervisory role.

Some people have discerned the possibility of a conflict between monetary policy objectives, on the one hand, and concern about the stability of the banking system, on the other. In a world in which a central bank might want to tighten its policies and raise interest rates, might it be restrained from doing so out of fear of the implications of such actions for the banking system? This is a possibility, but it would arise regardless of whether those two functions were combined in the central bank. Those charged with monetary policy have to take account of the implications of their actions for the financial system and everyone affected by it, regardless of whether they are supervising that system.

The monetary aggregates represent one channel for the transmission of monetary policy. In the United States, for example, various narrow and broad aggregates affect the economy. The broad aggregates have managed liabilities as important components. These liabilities are deposits of the banking system that are induced by banks' activities, rather than accumulated passively. To understand movements in money, therefore, it is important to understand the extent to which banks are aggressively bidding for deposits.

In the United States, the slow growth of some of the broader aggregates has been linked to the recent spate of bank mergers. In the wake of the savings and loan crisis, banks not only acquired considerable deposit liabilities (so that they did not need to go out and seek more), but they also sought to enhance their financial strength and build up their capital positions. Accordingly, they were less anxious to build up their balance sheets and, therefore, bid less aggressively for deposits. It is important for central banks to understand such processes in order to assess the growth of monetary aggregates.

Transmission of Monetary Policy Through the Credit Channel

The credit channel is another mechanism for the transmission of monetary policy. Much has been said about the "credit crunch" in the United States in the past few years. This phenomenon, which has been seen in other countries as well, describes a shift in the supply schedule for credit generated by the risks, interest rates, and other variables that enter into the calculations, that makes banks less likely to extend credit than they

would otherwise. The effect of the credit crunch was not fully appreciated early in the current cycle; it was through its examination process that the Federal Reserve discovered that banks' behavior was, in fact, changing in line with their desire to improve their financial condition and build up their capital positions. The Federal Reserve would not have gained that supervisory insight if it did not have a role to play in the examination process. The Federal Reserve was induced, at the time, to lower interest rates, in order to offset the effect of the restriction on the supply of credit by the banking system.

Transmission of Monetary Policy Through the Interest Rate Channel

Monetary policy also affects the economy through the interest rate channel. Consider, for example, how interest rates are set. Central banks set the official rates at which they lend to the banking system and, by controlling the supply of reserves, influence the federal funds rate. However, the spreads that the banks impose between those interest rates, deposit rates, and lending rates are functions of a number of variables that the central bank needs to understand. Once again, the insights gained from the examination process enable the Federal Reserve, as the nation's central bank, to do that.

Management of the Payment System

A second broad function of a central bank is management of the payment system. While the role of a central bank in the payment system varies from country to country, central banks typically play a role in large-value payment systems. In a sense, this situation is almost inevitable. Private banks hold deposits at the central bank. These deposits, as they are central bank money, are unlike other deposits. There is no credit risk associated with them. These deposits constitute an important element of the financial market structure.

While providing the opportunity for commercial banks to hold balances at the central bank, the central bank must also provide a means of transferring these balances from one account to another. Although these transfers are relatively few in number, they are very large in value. The need for credit might arise in such a system when the outflows from one account do not exactly match the inflows. In these contexts, there may be a need for the central bank to provide credit—intraday, at least, if not overnight. The central bank need not be the entity that runs a large-value payment system. However, because of the unique nature of the central bank—the lack of credit risk and the infinite liquidity that is available—it

offers a degree of certainty to the financial system that private participants cannot provide.

In any event, the central bank plays a role in supervising such a system. If the central bank itself runs the system, it must know the participants: to be able to extend credit on very short notice, it must have a feel for the financial condition of each participant in the system. If the central bank does not manage the overall payment system, it must oversee at least the privately run, large-value payment systems. The Bank for International Settlements (BIS) considered this issue a few years ago. The result has now become known as the Lamfalussy standards,[1] according to which countries agree that central banks will oversee large-value payment systems and ensure that these systems adhere to a set of standards and principles.

Lender of Last Resort

The lender-of-last-resort function is key to any central bank. Central banks may well be in a position of having to extend liquidity support to a bank that is in trouble. This process involves setting the discount rate and the other terms and conditions of the liquidity support. Once again, the need often arises to respond quickly to a situation that could otherwise get out of hand. The central bank must make a judgment as to whether the problem facing a troubled institution is one of illiquidity or insolvency. In the U.S. system and in most lender-of-last-resort structures, liquidity support is not provided to an insolvent institution. The judgment is not easy to make; it certainly is not easy to make quickly. Once again, the closer the central bank is to the supervisory process, the more it knows about that process. Similarly, the more central bank staff there are who are accustomed to evaluating the financial condition of the banks, the better able the central bank is to make those judgments properly and promptly.

Responsibility for examining or supervising all banks in a system will not necessarily enhance a central bank's ability to make these judgments. Even if a troubled bank is supervised by some other entity than the central bank, (which can easily happen, given the fragmented structure in the United States), the presence of experts accustomed to dealing with these issues on the central bank's staff is quite beneficial and important.

Crisis Management

While the functions of maintaining monetary stability, managing the payment system function, and acting as the lender of last resort all benefit from being combined with the supervisory function, the strongest

argument for a central bank role in bank supervision has to do with crisis management. Central banks are necessarily involved in reducing the likelihood that systemic crises might arise and resolving those crises that do arise. Systemic crises can arise from disturbances to financial markets and firms. These disturbances could spill over to other firms, or to the markets as a whole, and cause consequences for the real economy.

Central banks are necessarily involved because they alone can provide enough liquidity to deal with crises of systemic proportions. Beyond that, they are also the only participants with the broad knowledge of financial markets (and of the interactions among financial markets) that is needed to resolve such situations. Unlike the problems of an individual troubled bank, which can usually be dealt with through liquidation or merger, a systemic crisis by its very nature involves a wide range of entities, not just banks. Increasingly, as the world evolves, banks and other financial market participants (institutional investors, securities firms, insurance companies, or hedge funds) have become so interrelated that one needs this breadth of experience and knowledge that central banks can best supply. This is not to say that this knowledge could not be embodied in some agency outside the central bank; however, it is most likely to be found in the central bank.

Thus, in the aftermath of the equity market crash in October 1987, the Federal Reserve and other central banks provided liquidity to the market as an initial response. This action went a long way toward reducing the negative impact of that stock market crash. Beyond that, the Federal Reserve used its familiarity with the banks' relationships with the security houses, including the credit exposures of those houses, to help coordinate the provision of liquidity from individual banks to individual securities firms. This additional involvement of the Federal Reserve further minimized the negative impact of that systemic disturbance.

The mutually reinforcing nature of the various central bank functions must be stressed. Supervising banks enables the central bank to carry out its other functions more easily and rationally, as better information is available. At the same time, these other functions also bring something to the supervisory process. Central banks are better supervisors because they have this other experience to draw on.

The international aspect of this situation is particularly noteworthy. First, central banks are a close-knit group. They all have contacts with each other in various roles (in connection with monetary policy, payment system, supervisory, and other kinds of functions) and in various forums. These contacts are crucial, especially in the event of a systemic disturbance, because central bankers have developed working relationships with the individuals who will be dealing with the systemic crisis in their own

countries. In today's fast-moving world, these contacts are invaluable. Supervisors by themselves could not have that full range of contacts.

Second, many banks are themselves international in nature. These large, internationally active banks could well be the source of a systemic problem. A disturbance is much more likely to arise from the activities of a large, internationally active bank than from a small bank, or even a large, domestically oriented bank; the nature of international financial markets increases the likelihood that such a disturbance might spread from one country to another and develop into a systemic global crisis. In order to supervise internationally active banks, the supervising agency must have the requisite breadth of knowledge.

When the developing countries' debt crisis erupted in 1982 (clearly a major international event in financial markets of that decade), the Federal Reserve and some other central banks were well positioned to act promptly. They already knew, on the basis of supervisory reports (not economic research), that a large number of U.S. banks, including the largest, had substantial exposures to countries that could lead to debt-servicing difficulties. These exposures, in many cases, were large relative to their capital. When the crisis did erupt, the Federal Reserve knew which banks were exposed. It was familiar with the risk-analysis process followed by the supervisors and within the banks themselves. It also maintained contacts with the other central banks. The Federal Reserve was therefore able to organize liquidity support on short notice. Prompt action in the initial phase of dealing with the debt problem helped to minimize the macroeconomic consequences.

As the months and years of the debt crisis wore on, a tension developed between the need to protect and restore the financial strength of the banking system and the need to ensure that borrowing countries had at least conditional access (conditional upon policy actions on their part) to funding by the international community, without which they would not have been able to work out the problems in a reasonable way. A trade-off had to be made between the supervisory need to limit banks' exposures, on the one hand, and the macroeconomic need for funding, on the other. The central banking community was in the best position to make that kind of trade-off. Supervisors without responsibility for the macroeconomic consequences of their actions could not have made that trade-off as well as the central banking community did.

Another more recent example involves derivatives. Ongoing work is aimed at managing the risks associated with derivatives in a wide range of areas. Not only are all of the supervisory bodies in the United States involved in this, but the market itself is also involved. In addition, the matter is of concern to banks, securities firms, and the U.S. Congress.

The range of aspects relevant to this discussion cuts across many different kinds of functions, putting central banks in a good position to deal with this issue. Within the Federal Reserve, a working group of experts on the legal, research, international, payment, and supervisory aspects has been set up to ensure that their various perspectives are not overlooked in making regulatory judgments about the derivatives markets. Supervisors on the Basle Committee on Banking Supervision are also very much interested in derivatives, which they are discussing in the context of market risk and off-balance-sheet risk and the capital charges that need to be placed. Other groups are also discussing derivatives.

17B. Bank Supervision in the G-7 Countries

ELIZABETH ROBERTS

This chapter addresses central bank involvement in banking supervision, primarily in the Group of Seven (G-7) countries. In the United States, the Federal Reserve (the central bank), in addition to specific domestic banking supervisory responsibilities, is responsible for monitoring the combined U.S. operations of foreign banking organizations. As part of this process, it has attempted over the years to understand better how these banks are regulated in their home markets.

A specific effort was made by the Federal Reserve to catalog banking supervision and regulation practices in the G-7 countries. Central banks were found in all but one G-7 country (Canada) to be either de jure or de facto involved with the supervision and regulation of banks. More broadly, central banks have either total or shared responsibility for banking supervision in three-fourths of the members of the Organization for Economic Cooperation and Development. Therefore, one can assume that most countries have come to understand that banking supervision and regulation have economic consequences that are important for stability and economic growth. However, the specifics of each central bank's role vary from country to country, depending importantly on cultural and historical features, as well as on the institutional structure and degree of concentration within the home country financial system.

Nine Factors Affecting Banking Supervision and Regulation

A recent review by the Federal Reserve of supervisory practices in the G-7 countries included analyses of nine specific areas relating to banking supervision and regulation:

- the legal basis for supervision;
- the agencies involved in banking supervision;
- chartering responsibilities;
- examination authority;
- reliance on external auditors;
- statistical reporting and surveillance;
- corrective measures and sanctions;
- rule-making responsibility; and
- deposit insurance.

After briefly addressing each of these nine factors, this chapter summarizes the findings for each of the G-7 countries.

Legal Basis for Supervision

In each of the G-7 countries, a specific law designates responsibility for banking supervision. In some countries, the banking supervisors historically have relied more on a series of agreements than on formal exercise of statutory powers. This was certainly true of the United Kingdom prior to passage of the Banking Act, 1979.[1] However, in recent years, particularly in Europe, the various EC banking directives have given impetus to formalize banking supervision and regulation.[2]

Agencies Involved in Banking Supervision and Regulation

In numerous countries, there is a single supervisory and regulatory agency—the central bank, the ministry of finance, or a separate banking agency. In other countries, two or more agencies are involved in the supervisory and regulatory function. It is interesting to note which agency is responsible for banking supervision, and, if more than one agency is involved, how the responsibilities are divided among the agencies and how they interrelate with one another.

Chartering Responsibilities

A key function within any supervisory structure is the chartering or licensing of new institutions and the various requirements that go along with this chartering process. This function is usually tied to other supervisory responsibilities. Although, in some countries, such as France, it is the responsibility of a separate agency, most supervisors approve the formation of banking institutions for which they will ultimately maintain responsibility.

Examination Authority and Reliance on External Auditors

The fourth and fifth factors, examination authority and reliance on external auditors, are really intertwined. For U.S. supervisors, the examination function serves as the backbone of the supervisory process. In many other countries, however, the supervisory agencies rely instead on the reports of external auditors. In addition, many countries use a system that is a hybrid of examinations, usually conducted once every several years, and reports compiled by external auditors in the interim years.

It is important to note which of these three methods is utilized. In those countries where the supervisors conduct on-site examinations, the frequency with which these examinations are conducted, and by which agency or agencies, is significant. Meanwhile, where external audits are used, how much control the supervisory agencies have over the independent audit process is important. For example, does a bank have to choose an auditor from a preapproved list compiled by the supervisory agency? Do the supervisors have any input into the content and focus of the audits? What are the responsibilities of the independent auditors with regard to communicating problems at a specific institution to the supervisory agencies? Finally, in those cases where the supervisors rely on the reports of external auditors, do the supervisors have any examination authority of their own, either in general or in extraordinary circumstances?

Statistical Reporting and Surveillance

Obviously, supervisors and external auditors cannot be in all banks at all times. Therefore, statistical reporting and off-site surveillance are important tools in the supervisory process. The continuing off-site monitoring or surveillance of financial institutions should constitute a significant portion of any supervisory program. What type of information is collected and how often, and how this information is utilized by the supervisory agencies, is important.

Corrective Measures and Sanctions and Rule-Making Responsibility

The seventh and eighth factors are fairly self-explanatory. A critical aspect of any supervisory regime is the ability to require corrective action and the legal authority to impose sanctions in the most serious circumstances. Similarly, the responsibility for rule making is critical to any supervisory structure. Different countries allocate this responsibility in different ways.

Deposit Insurance

With regard to the ninth factor, deposit insurance plans, if they exist at all, vary across countries. These plans can range from formal, government-sponsored plans, to less formal, private plans, arranged by organizations such as bankers' associations. It is important to understand what, if any, role the banking supervisory authorities have in administering the deposit insurance plan and, conversely, what, if any, role the deposit insurance agency plays in banking supervision.

Specific Countries

United States

The United States is in a unique position among the G-7 countries because of its dual banking system, in which, in most cases, federal and state officials share authority over individual institutions. In addition, the United States has a diverse banking system, with over 11,000 commercial banks, a large number of small institutions, and a system that, until recently,[3] limited the activities of individual banks primarily to one state.

The dual banking system in the United States has led to the creation of a rather complicated banking supervisory structure. Commercial banks in the United States have the option of obtaining state or federal charters. National banks, or those with federal charters, are supervised by the Office of the Comptroller of the Currency, which is an agency of the Department of the Treasury. State banks, which receive their charters from the states in which they operate, are subject to supervision not only by these states but also by a federal banking agency. This responsibility is split between the Federal Reserve, which supervises state-licensed banks that are members of the Federal Reserve System (so-called state member banks), and the Federal Deposit Insurance Corporation, which supervises state-licensed banks that are not members of the Federal Reserve System (so-called state non-member banks). Many banks are owned by bank holding companies, which are supervised by the Federal Reserve. Unlike most other countries, savings banks and credit unions in the United States are supervised by yet two additional supervisory agencies: the Office of Thrift Supervision, for savings banks, and the National Credit Union Association, for credit unions. Proposals are made periodically in the United States to streamline the banking supervisory structure.

France

France, like the United States, has multiple agencies involved in supervision.[4] These agencies, however, are divided along functional responsibilities, as opposed to categories of banking institutions, as in the United States. Currently, several primary agencies are involved in banking supervision and regulation in France. The Bank of France (the central bank) exercises indirect but significant authority over the supervision and regulation of the banking system. The Banking Commission, which is responsible for ensuring the safety and soundness of all credit institutions and monitoring compliance with banking laws and regulations, is chaired by the Governor of the Bank of France and is staffed by central bank employees. The Banking Regulations Committee, on which the

Governor of the Bank of France acts as Vice-Chairman, establishes prudential regulations and accounting standards. The Credit Institutions Committee, on which the Governor of the Bank of France serves as Chairman, is responsible for chartering individual banking institutions.

It is apparent that the French system assigns tasks such as rule making and chartering to institutions separate from those that are charged with the day-to-day supervision of banking institutions. The unifying force is the indirect involvement of the Bank of France in all of the various supervisory functions and its very direct involvement—because of the staffing of the Banking Commission—in the day-to-day supervision of the banks.

Japan

In Japan, banking supervision and regulation is the legal responsibility of the Ministry of Finance, although the Bank of Japan (the central bank) is also involved de facto in the monitoring, analysis, and supervision of banks and in the resolution of problems within the banking sector. While the authority of the Ministry of Finance is statutory, the Bank of Japan's authority is contractual, based on an individual agreement entered into by each bank using central bank services. Credit institutions must obtain the approval of the Ministry of Finance in order to commence operations.

The Ministry of Finance and the Bank of Japan share examination responsibilities and conduct regular on-site examinations, generally in alternate years. The Bank of Japan is involved in the examinations of all commercial banks, as they all maintain accounts with the central bank. Both the Ministry of Finance and the Bank of Japan conduct extensive off-site monitoring of financial institutions by reviewing statistical returns and meeting periodically with bank management.

The Ministry of Finance has sole legal authority to impose corrective sanctions on banks. However, the Bank of Japan may use its ability to withhold its central banking services from a particular bank to influence that bank, if necessary.

Germany

The supervisory situation in Germany is particularly interesting because of the frequent misperception that the Deutsche Bundesbank (the central bank) is not involved in the day-to-day supervision of German banks. The banking law established the Federal Banking Supervisory Office as the primary banking supervisory body in Germany.[5] The Supervisory Office exercises its supervisory functions in close coordination with the Bundesbank. The Supervisory Office is formally the

lead supervisor. However, with a single office in Berlin, it relies heavily on the Bundesbank, which has regular dealings with banks and a network of offices throughout Germany. In practice, a partnership exists between the Supervisory Office and the Bundesbank.

Many of the Bundesbank's supervisory functions are conducted through the state central banks, which are akin to Federal Reserve Banks in the United States. The state central banks are actively involved in the ongoing surveillance of financial institutions through the collection and analysis of monthly and quarterly financial returns, as well as through the annual reports of external auditors. Both the Bundesbank and the Supervisory Office have the power to conduct on-site examinations. In practice, however, with the exception of the foreign exchange examinations, which are conducted by the Bundesbank, they rely on the annual audit reports.

All so-called sovereign functions, such as the chartering of individual institutions, are the responsibility of the Supervisory Office. In practice, these administrative acts are conducted only after consultation with the Bundesbank. The Supervisory Office issues regulations but must, by law, confer with the Bundesbank before doing so. The degree to which the Bundesbank is entitled to participate is based on the extent to which the regulations affect its central banking functions. Therefore, when issuing regulations concerning capital and liquidity, the Supervisory Office is required to reach agreement with the Bundesbank while, on other matters, the Bundesbank has merely to be consulted. It is apparent, however, that the two agencies reach agreement on virtually all major regulatory and supervisory matters.

Although both the Supervisory Office and the Bundesbank are authorized to examine banks, they almost exclusively rely on the reports of external auditors. Guidelines for the contents of these audit reports are formally established by the Supervisory Office. These reports are routinely submitted to the state central banks, which review them and prepare summaries. The reports and summaries are, in turn, provided to the Supervisory Office; the Bundesbank, in Frankfurt, normally receives only the summary report.

United Kingdom

The United Kingdom is one of two countries in the G-7, along with Italy, where banking supervision is in effect the sole responsibility of the central bank. Banking supervision in the United Kingdom is conducted by the Bank of England (the central bank), which is the statutory supervisor of all financial institutions authorized under the Banking Act.[6] All

institutions engaged in banking activities in the United Kingdom must be authorized by the Bank of England. The Bank of England, like the German banking authorities, relies primarily on the reports of external auditors, rather than on on-site examinations.

The 1987 Banking Act created an advisory committee to the Bank of England known as the Board of Banking Supervision.[7] The Board comprises nine members, three of whom are the Governor, Deputy Governor, and one of the executive directors of the Bank of England. The role of the six independent members is to advise the bank members on the exercise by the Bank of its supervisory functions under the Banking Act. In addition, following passage of the 1986 Financial Services Act,[8] the concept of a lead regulator was developed to avoid duplication of supervisory efforts for those institutions conducting a wide range of financial functions. This arrangement provides for one supervisor to monitor an institution's financial condition on behalf of all of the regulatory entities. The Bank of England has been designated as the lead regulator for all banks engaged in expanded activities.

Italy

The other G-7 country with essentially a single supervisor is Italy. The Bank of Italy (the central bank) is responsible for the supervision and regulation of the banking system, subject to broad directives from the Interministerial Committee for Credit and Savings. The Bank of Italy is empowered to authorize the establishment of new banks and the opening of new branches. The Bank of Italy is responsible for establishing regulations for credit institutions within the scope of its authority.[9] It also has the power to prescribe minimum capital levels, establish lending ceilings for banks, and exercise ongoing controls through a number of returns, inspections, and prudential ratios. The Bank of Italy is also responsible for ensuring that the banks comply with these regulations.

Canada

The only G-7 country where the central bank has a very limited role in supervising and regulating the banking system is Canada. The Office of the Superintendent of Financial Institutions (OSFI) is the sole supervisory authority for banks, trust and loan companies, insurance companies, investment companies, and cooperative credit societies. OSFI is part of the Department of Finance, reporting to the Minister of Finance. Although the Bank of Canada (the central bank) does not have responsibilities for prudential supervision, it routinely receives most of the supervisory reports filed with the Superintendent.

In addition, the Governor of the Bank of Canada is a member of the Financial Institution Supervisory Committee, which was established to facilitate the confidential exchange of information among its members on all matters related to the supervision of financial institutions. The other members of this committee are the Superintendent of OSFI, the Deputy Minister of Finance, and the Chairman of the Canadian Deposit Insurance Corporation.

Other Issues

There are several other issues related to central bank participation in banking supervision and regulation. For example, it can be argued that central bank involvement in banking supervision is less critical in countries where the local banking market is highly concentrated. In these countries, the scope for informal involvement by the central bank, through personal relationships and ongoing contacts independent of the supervisory process, is far greater than in some countries, such as the United States. A good example of this is Switzerland, where the Swiss National Bank has no formal role in banking supervision and regulation. However, the Swiss banking system is highly concentrated; therefore, in the event of a nationwide systemic problem, there are probably only three banks with which the Swiss National Bank would need to work. Undoubtedly, personal relationships would allow it to do so quite easily.

There is also a political aspect to central bank involvement in countries where the independence of the central bank is a controversial issue. For that reason, central banks in numerous countries are, de facto, more involved in banking supervision and regulation than may be apparent on the surface. Many central banks wield their influence over the banking system behind the scenes and as discreetly as possible, because they do not want to add to the controversy regarding their independence by emphasizing their critical role in banking supervision and regulation.

The role of central banks in the supervisory process is subject to periodic review. Such a review was conducted recently in France, in the context of the new law establishing the independence of the Bank of France.[10] However, the role of the central bank in the supervisory process was left unchanged. In the United Kingdom in late 1993, the Treasury and Civil Service Committee of the House of Commons reviewed the role of the Bank of England in several areas, including supervision.[11] It was concluded that there was no overwhelming case to move supervisory responsibility outside the Bank of England. The role of central banks in banking supervision and regulation will be a topic of interest for many years to come.

COMMENT

JOHN P. DANFORTH

The topic of the role of central banks in banking supervision and regulation is of significant interest. This comment considers bank supervision and regulation in the United States from a somewhat different perspective, that is, from more of a banking industry than a central bank perspective.

For many years, there has been academic concern about the role of the central bank in bank supervision. This concern has been related to what some would describe as the possibility of an inherent conflict between the monetary policy and supervisory roles. There are arguments on both sides of this debate.

A more significant issue for banks is the complex and overlapping system of supervision and regulation in the United States at present. Banking organizations often are subject to supervision and regulation by several federal and state banking supervisors. The prior system of geographic restrictions on banking in the United States caused the development of a truly bizarre system of supervision and regulation that sometimes led to a situation in which an institution with banks in several states had several charters—a national bank charter, a state member charter, a state nonmember charter, and a federal savings bank charter. Such an institution is subjected to extremely complex and sometimes conflicting regulatory guidelines.

This situation was severely exacerbated in the United States as the bank supervisory agencies became more aggressive and intrusive in performing their supervisory functions, in response to both the significant losses passed on to U.S. taxpayers because of the debacle in the thrift industry and the surge in bank failures, as measured by the number of institutions and the amount of assets affected during the late 1980s and early 1990s. As the supervisory authorities became more aggressive, the difficulties associated with overlaps and redundancies in supervisory authority became more pronounced.

This development, rather than concerns about the independence of monetary policy from supervision, led certain individuals to believe that the issue of supervisory reorganization should be revisited, and that legislation should be adopted to simplify a convoluted system of regulation. There have been numerous proposals.[1] From a banker's perspective, the great majority of banks in the United States are quite comfortable having

the Federal Reserve in a supervisory role. Some banks, as a response to the policies and standards adopted by the Comptroller of the Currency, the supervisor of national banks, have altered their charters so as to be regulated by the Federal Reserve rather than by the Comptroller of the Currency. In addition, these banks are enjoying the advantages associated with having the same regulator for their holding companies as for their subsidiary banks. A number of organizations have, in fact, acted as missionaries, advocating that more institutions replace the Comptroller of the Currency as their supervisor by the Federal Reserve by changing their charters from national bank charters to state member bank charters.

For this reason, most bankers in the United States are earnestly opposed to a thorough streamlining of the country's regulatory and supervisory process. Under the current regime, they are permitted to change their charter and supervisor should they become dissatisfied with the quality or rigor of supervision provided by that supervisory authority. Apparently, this is a very unusual situation. Some observers have warned of the possibility of a competition in laxity of regulation that allowing bankers a choice might promote in the banking community. Nevertheless, in the United States today, the prevailing concern among bankers is that having only one supervisor might lead to a situation in which there would be no market discipline to encourage that supervisor to deal reasonably with banks. Perhaps it is the inherent distrust of government in the United States that allows that view to be so prominent.

In conclusion, based upon the foregoing, the Federal Reserve is not likely to be excluded from banking supervision activities in the United States. Moreover, no change is likely to be made to the current situation, whereby banks can leave one primary supervisor for another should they believe that they are not being treated fairly by that supervisory authority.

Chapter 18 Who Should Be the Banking Supervisors?

18A. Some General Considerations

IAN H. GIDDY

[The banking regulatory system is] a crazy quilt of conflicting powers and jurisdictions, of overlapping authorities and gaps in authorities. . . .

—Board of Governors of the Federal Reserve System
Twenty-Fifth Annual Report (1938)

Introduction

This chapter evaluates the merits of a country's having an independent agency to supervise banks, compared with housing the banking supervisory function in the central bank or the finance ministry. Independence, the chapter argues, is in the best interests of depositor safety and bank efficiency. It also leaves the central bank free to concentrate on its proper function, monetary policy. However, the U.S. experience demonstrates the difficulty of attaining the ideal of an independent agency. Where there is a serious risk of the bank supervisor's task becoming politicized, the supervisory task should be housed wherever it can be most shielded from the pressures to compromise its principal task, maintaining the soundness of the banking system.

At the risk of oversimplifying, one can divide a government's interest in the banking system into three public policy objectives: implementing monetary policy, preserving the integrity of the banking system, and allocating credit. The function of the supervisor of banks can, in most cases, best be fulfilled by segmenting its role from those of the central bank and the ministry of finance because each institution has a distinct purpose in mind in regulating banks, and attempting to achieve two or more goals with one instrument ensures that there will be conflicting priorities. To understand this idea more fully, the optimum allocation of the three goals to each of the three agencies must be explained, and the extent to which the goals are both interdependent and conflicting must be examined.

Three Roles of Bank Regulation

All arguments for government intervention in financial markets in general, and the banking system in particular, fall within one or more of the three basic categories of objectives.

Controlling the Volume of Liquidity

First, it is generally agreed that it is a legitimate responsibility of government to control the volume of liquidity in a currency-based banking system. Payments are usually made in this kind of system by transferring the ownership of demand liabilities in commercial banks. This control is necessary if for no other reason than to keep the growth of the money supply from fueling excessive price inflation. Mandatory reserve requirements on the deposit liabilities of banks and the open market purchase and sale of (public sector) securities are the major traditional means used by monetary authorities to achieve this goal.[1] A related set of policy tools are those that aim at fixing exchange rates through official intervention—the buying and selling of foreign currencies by the central bank. These activities all aim at achieving the above-mentioned public policy objective of implementing monetary policy.

Preventing Bank Failure

The second objective of regulating the behavior of banking institutions is to prevent bank failures, for the sake of both depositors and the financial system in general. The collapse of a bank, because it holds the means of payment and liquid balances of business firms and households, can have a disproportionately disruptive effect on a community and even on the whole financial system if failure (or the fear thereof) leads to a banking panic. This function, which corresponds to the objective of maintaining the integrity of the banking system mentioned above, is explored in more detail later in this chapter.

Ensuring the Availability of Credit

The third objective of government intervention in the banking system is to ensure the availability of credit for certain economic activities, groups, and institutions. In effect, this means that the government allocates credit to groups to whom the private market will not grant sufficient funds or provides favored sectors with credit at below-market terms.

Division of Labor

These three objectives can be associated with the core roles or functions of the three agencies: the central bank, the bank supervisor, and the finance ministry.

Central Bank

The role of the central bank is to monitor and control the adequacy and value of the national currency through monetary policy instruments. In addition, because the central bank serves as banker to banks, it is the ultimate vehicle through which banks transfer payments to one another. Hence, a secondary duty of the central bank is to ensure the smooth, continuous operation of the payments system. Finally, because the central bank is the producer of money, it must serve as the lender of last resort to the banking system as a whole.

Banking Supervisor

The function of the agency supervising banks is to preserve the integrity of the banking system. Its function does not stem from anything to do with the implementation of monetary policy, but from the explicit or implicit insurance of bank deposits that is required to allow the unimpeded transfer of bank liabilities as the means of payment.

Ministry of Finance

The proper function of the ministry of finance is to fund and manage the nation's budget. Thus, the ministry must administer a system of taxes, fees, and other means of raising funds, as well as administer the allocation of resources in a way that seems fit to the nation's polity. One way to allocate resources is through the banking system. If it is the job of the finance ministry to oversee the nonmarket disposition of resources, including credit, this aspect of banking should in principle be separated from the other two aspects, namely, implementing monetary policy and preserving the soundness of the banking system.

Banking Supervision and the Central Bank as Lender of Last Resort

Things tend to go awry when the supervisory and the lender-of-last-resort functions are confused. This section examines specifically the

purpose of banking supervision. The starting point is the central bank's lender-of-last-resort function.

As noted above, banking occupies a special place in public policy because bank liabilities, notably demand deposits, serve as the principal means of payment for the economy. The central bank's role as a lender of last resort is to avert the consequences of a run on these deposits. Such an event usually begins with the erosion or disappearance of a bank's equity position as a result of sudden and excessive loan losses. Depositors concerned about the safety of their funds in a particular bank will place them in institutions considered safer. Even worse is when the failure of one bank casts doubt about the soundness of other institutions, leading depositors to demand currency. In monetary theory, the sudden demand for currency relative to demand deposits is equivalent to a drastic increase in reserve requirements, because currency in circulation, together with the demand liabilities of the central bank to commercial banks, constitutes the reserve base, or high-powered money. If the bank is fully loaned up, it cannot draw on the reserves that it must hold with the central bank when it experiences (net) deposit withdrawals. The bank must instead sell marketable securities and call in loans. If these actions are not sufficient, and often they are not, the bank can go out and borrow funds in the interbank or money markets. If the withdrawal of deposits was caused by concern about the soundness of the bank, such attempts will be unsuccessful, and the institution will have to close its doors. It is here that the central bank enters the picture as the lender of last resort: because it can create domestic money essentially without limit, it can without difficulty make funds available in the form of either currency or central bank liabilities.

In a modern banking system, the mere knowledge that the central bank is willing and able to supply additional funds to banks experiencing liquidity problems (a euphemism for these banks' inability to satisfy the requests of depositors for the return of their funds) will suffice to prevent sudden shifts out of demand deposits into currency.

Deposit Insurance and the Need to Counter Moral Hazard Incentives

Most nations limit the damage of possible bank failures by employing some form of deposit insurance, either by explicitly insuring or implicitly backing up deposits. In many countries, auxiliary institutions insure deposits and assure depositors that their funds are available without undue delay, thus preventing runs on banks from occurring in the first place. Some countries do this through their private banks, arranging

mutual insurance or "lifeboats" in which sound banks agree to support or absorb banks in trouble.

A system of deposit insurance and explicit or implicit promises by the central bank to come to the rescue of depositors involves a "moral hazard" that has long been recognized: when depositors become impervious to risk, it is in the interest of shareholders that their agents, that is, management, undertake investments that yield higher returns but carry more risk. One approach to capturing this effect more formally has been developed by Robert Merton.[2] By using option theory, he showed that the insurance in essence permits the operators of a financial institution to "put" the claims of the depositors to the central bank or another (government) insurance institution whenever the market value of the assets is less than that of the deposit liabilities. The value of a depository institution to a bank's operators is greatest when the net worth is zero, that is, when the option is "at the money." Without deposit insurance, the operators of the bank must pay a default risk premium in order to attract funds. If that premium were to be priced fairly, it would approximate over time the difference between the net worth (exercise price) and the value of the option. The nature of the option also suggests the nature of the assets that the bank will buy, if unconstrained: higher-risk, higher-return assets. The higher the risk, the more value the bank has for the operators, as any upside gain benefits them directly, while the downside risk is absorbed by the institution that bails out the failing bank. Furthermore, when the bank has large negative net worth, the incentive for reckless transactions or even fraud is enhanced. While these values are not without cost in terms of possible regulatory scrutiny and probability of damaged managerial reputations, the potential for gain is also considerable. In any case, the discipline of creditors (depositors) to monitor the firm's activities very closely in such circumstances is greatly diminished.

Prudential Regulation: Asset Side Versus Liability Side

The function of banking supervision is to prevent banks from exercising the incentive to buy higher-risk, higher-return assets. When the authorities (or other market participants, in the case of a mutual insurance scheme) underwrite a portion of a bank's debt, they will invariably have to constrain the asset allocation decisions of the individual financial institution, either directly or through liability-side incentives. It is easily shown that liability-side prudential regulation, such as deposit insurance fees or capital requirement related to risk, is more desirable.

Asset-side prudential regulation entails the involvement of the supervisor in a bank's business decisions. The goal is to ensure that the bank's

funds are prudently invested and that these investments are properly diversified. Statutory and administrative limitations are put on the bank's freedom to conduct business in certain strategic areas (for example, insurance, commodities trading, and underwriting). Assets cannot be too concentrated in any one borrower or industry. Restrictions on the pricing of funds (interest ceilings) and the detailed examination of individual loans are part of the regulatory bag of instruments used in asset-side prudential regulation.[3] Certain investments are generally taboo (in the United States, corporate bonds[4] and equities); others are required.

Virtually everywhere, the public regulation of commercial banks includes restrictions on entry into the banking business—restraints that cover both the establishment of ***de novo*** institutions and expansion through branching—on the theory that competition must be limited to prevent it from becoming "ruinous." Such measures, intended to assure the soundness of banks, are often anticompetitive and, therefore, may deprive the public of differentiated and least-cost banking services.

The question thus arises as to where the government's responsibility to preserve the soundness of financial institutions ends and where the obligation to foster competition begins. Similarly, the dividing line between the objectives of prudential banking supervision and of credit allocation becomes blurred under asset-side prudential regulation. Which investment policy might better appear to promote the stability and soundness of financial institutions than that of keeping a large proportion of their assets in government paper? The reality is that asset-side prudential regulation is easily transmuted into indirect credit allocation.

Because credit allocation is, almost by definition, highly political, a direct and open approach is avoided whenever possible. Instead, existing private financial institutions are induced, by various means and pressures, to take into consideration reasons other than expected return and risk when deciding where to invest funds. Thus, indirect credit allocation always makes the portfolio composition of a financial institution inferior to that which its management might choose; otherwise, it would not be necessary to apply pressure. In the United States, for example, banks are expected to channel funds into local businesses, particularly small ones, and into community institutions, such as school authorities and municipalities. In particular, the Community Reinvestment Act[5] is intended to ensure that the credit needs of the entire community, including low- and moderate-income neighborhoods, are met.[6] Likewise, the provision of cheap credit to home buyers and farmers has also been a preferred objective for U.S. banking regulation. In Western European countries, such policies are even more widespread, although different criteria prevail;[7] in

some developing countries, the financial systems appear to be completely paralyzed by extensive networks of credit allocation.[8]

Liability-side prudential regulation seeks to get the supervisor out of the business of second-guessing bank asset decisions. Instead, it says to banks, in effect, "buy whatever assets you choose, but focus on maintaining an adequate capital position while restricting the composition of assets: reserves, liquid investments, and loans." Control is exercised through the establishment of balance sheet ratios, consisting of maximum and minimum relations between different categories of assets and liabilities. Since the Basle Capital Accord[9] on capital requirements was adopted, many countries have shifted to liability-side regulation.

A variant of this approach is risk-based deposit insurance fees, which are being introduced in a tentative fashion in the United States. Under this approach, premiums are based on "the probability that the deposit insurance fund will incur a loss with respect to the institution."[10] The differential between the average assessment rate and that imposed on the most risky institutions must be at least 10 basis points.[11] Effective January 1, 1993, the Federal Deposit Insurance Corporation (FDIC) adopted an interim deposit insurance system, with premiums ranging from 23 to 31 basis points on deposits and an estimated average premium of 25.4 basis points. Under this interim system, banks are classified according to both supervisory evaluations and capital categories similar to those used for capital-based supervision. Again, there is no direct need in this system to constrain asset-side decisions.

In short, an independent agency to supervise banks, concentrating on liability-side regulations and free of pressures to allocate credit or serve other public policy objectives, will do the best job of ensuring the soundness of the banking system. Realism, however, demands that one recognize that no agency can operate outside the political system. Moreover, regulators themselves are subject to moral hazard incentives, which can be explained in the context of economic incentive theories explaining the relationship between the regulator and the regulated.

Behavior of Regulators

The modern view of bank regulation espoused by Edward Kane and others[12] is based on a correspondence between concepts germane to theories of market behavior, on the one hand, and the manifestations of regulatory activity, on the other. Financial regulatory services are produced and delivered by governmental entities because government sponsorship confers a number of marketing advantages on regulatory entities, and because regulators have the opportunity to redistribute income, a politi-

cal process by definition. Financial regulatory services consist of efforts to monitor, discipline, or coordinate the behavior of individual financial service providers for a common good or objective. Regulators also compete for market share; the broader their reach, the greater their power, prestige, job satisfaction, and other emoluments.

In exchange for explicit and implicit revenues, producers of regulatory services enhance the confidence of the customers of their regulatory clientele. From the point of view of those regulated, however, the costs imposed on them by regulators explicitly and via constraints on operations reduce the value of regulatory services. This perception represents an incentive to "shop" regulators that involves some transition costs but also acts as a constraint on regulators.[13] These ideas are dramatically illustrated in the United States, particularly through the debate on the proper locus for bank supervision that took place in 1993 and 1994.

Where Should Banking Supervisory Authority Lie? The U.S. Debate

The quotation at the beginning of this paper reflects the well-known fact that the U.S. banking regulatory system is a set of overlapping and even conflicting jurisdictions. The patchwork regulatory structure keeps federal examiners from getting a good handle on the industry. For example, a large bank holding firm may own a nationally chartered bank, a thrift, and a state-chartered bank that is not a member of the Federal Reserve. Each of the four regulators—the Federal Reserve, the Office of the Comptroller of the Currency, the FDIC, and the Office of Thrift Supervision—examines a part of the firm, but no regulator has responsibility for examining it as a whole. Most worrisome, a multiple-regulator system can be exploited by aggressive bank holding firms. Suppose a firm's executives are unhappy with the Office of the Comptroller of the Currency's supervision of one of its banks. They can threaten to change the charter or membership status of the bank—to shop around, in other words, for a more lenient regulator. Because no regulator wants to lose banks to another agency, lawmakers have long warned that the shopping-around threat encourages lax regulation and thus increases the likelihood of bank failures, for which taxpayers are liable.

As part of its plan to reform the structure of government institutions, the U.S. Department of the Treasury proposed in late 1993 that an independent banking supervisory agency be established.[14] Initially, the new agency was to be within the executive branch; later, the proposal was amended to make the agency separate and independent. The proposal envisioned five commissioners: the Secretary of the Treasury, a member

of the Federal Reserve Board named by the Board, and three members appointed by the President and confirmed by the Senate. The President would designate one of the commissioners as chairperson, subject to Senate approval. Under this scheme, the FDIC would retain its core role as manager of the taxpayer-backed deposit insurance system. Although the Federal Reserve would lose its hands-on examination authority, it would retain other key powers, such as the ability to make direct loans to troubled banks.

The idea was not new. This plan has been discussed in one form or another over the past 30 years. It has always failed because the Federal Reserve, the FDIC, and the Office of the Comptroller have opposed giving up any control over financial institutions, and banks have joined their regulators in opposing a merger because of the uncertainties that would result from being regulated by a new federal agency. The U.S. Congress has always gone along with this consensus; the current round proved to be no exception.

The Federal Reserve was not interested in any arrangement that left it without a substantial supervisory role. It pointed out that supervisory functions predate and are additional to the more purely monetary functions of open market and foreign exchange operations: "A basic [Federal Reserve] responsibility, and the reason for its founding, was to assure a 'stable and smoothly functioning financial payments system' and to 'head off and deal with financial disturbances and crises' to the extent possible."[15] Chairman Alan Greenspan argued that a hands-on supervisory role is "indispensable" for maintaining the Federal Reserve's "'unparalleled knowledge' of financial systems, markets, institutions and relationships needed to carry out its key responsibilities 'at the nexus of monetary policy, the payments system, and bank supervision and regulation.'"[16] President of the New York Federal Reserve Bank William J. McDonough also "warned that 'sooner or later there will come a crisis,' and the [Federal Reserve] will fight 'with absolute determination and dedication' to safeguard the economy, but that 'Congress should not strip us of the weapons we need—it is simply too dangerous.'"[17] The Federal Reserve's counterproposal was to establish two supervisory agencies (one of which would be the Federal Reserve itself).[18]

Then Secretary of the Treasury Lloyd Bentsen argued that Germany's Bundesbank did not have supervisory authority over banks and did not need it to conduct monetary policy.[19] He questioned the Federal Reserve's contention that more than one federal banking supervisor was necessary.[20]

The industry rallied behind the Federal Reserve. No banker wants to get on the bad side of a regulator. The result is that, at present, reform efforts are at a standstill.

Central Bank Independence

Ironically, the argument in favor of an independent supervisory agency runs along the same lines as the argument for an independent central bank. With the independent Bundesbank playing a powerful role, Germany has greatly strengthened its reputation for resisting inflation and safeguarding the currency. Meanwhile, the United Kingdom is considering fundamental moves toward central bank independence to the end of ensuring the benefits of price stability for its economy.

Indeed, a movement toward greater independence for central banks is sweeping across the globe. In Europe, central bank independence has become a prerequisite for participating in the final stages of monetary union;[21] major structural changes for independence are in place or have been proposed in Belgium, Italy, France, and Spain.[22] With its reorientation toward open economies and market-based policies following the debt crisis, Latin America has seen major moves toward greater central bank authority or independence in Chile, Venezuela, Mexico, and Argentina.[23] The transitional economies of Eastern Europe are experimenting with alternative approaches. Also, New Zealand has introduced an imaginative scheme for targeting inflation, and South Africa has fortified the powers of its central bank.

The independence of the central banks must be continually defended in order to depoliticize the process of money creation and develop the required public determination for monetary stability. Bundesbank Chief Economist Otmar Issing puts the case for central bank autonomy succinctly and fervently:

> Resistance to making the central bank independent always reflects the intention of reserving access to money creation to policymakers. This has never been good for the value of money anywhere.[24]

Statutory independence does not work everywhere. In the United Kingdom, an independent panel decided against recommending a "generalized" mandate of the Bundesbank model, feeling that, as it relied too heavily on the Bundesbank's unquestioned credibility and the German electorate's strong support of price stability, it was not appropriate for the United Kingdom.[25] The panel chose instead a model with a more precise numerical inflation target, closer to the approach of New Zealand, whose anti-inflation credentials, like those of the United Kingdom's, were not so firmly established. The panel recommended that "price stability" be the sole statutory objective of the Bank of England and that the bank formulate and announce short-run targets for inflation and control short-term interest rates.[26] The Government could *in extremis* overrule the

bank and resume control of monetary policy but only to suspend by parliamentary action for six months the bank's objective of price stability.[27]

Conclusion: Implications for Independence of Bank Supervision

In an ideal world, the banking supervisory agency would be separate and independent and have the sole function of administering liability-side prudential regulation. As the U.S. experience indicates, however, neither central banks nor supervisory agencies operate in a political vacuum. The U.S. central bank, similar to those of Germany and Switzerland, is able to maintain its independence because it has a strong constituency. An independent, powerful Federal Reserve is in the interest of the nation's largest financial institutions, which worry about the health of the national and global economies and have confidence in the Federal Reserve's ability to provide stable, low-inflation growth. Banks now supervised by the Federal Reserve offer a natural constituency in favor of its continued independence. The implication, it seems, is that a single, federal banking supervisory agency could not in fact maintain the desired independence unless it were able to garner a similar degree of constituent support.

These considerations lead to a second model of bank supervisory independence, one along the lines of the British proposal. Where there is a serious risk of the bank supervisor's task becoming politicized, the supervisory task should be housed wherever it can be most shielded from pressures to compromise its principal task, maintaining the soundness of the banking system. Instead of focusing the banking authorities' efforts by segregating the agency, one could place strict limits on the goals and powers of the supervisors, wherever they are housed. The goal would be to ensure the stability of the banking system, and the regulators would not be permitted to engage in activities, such as credit allocation, that were detrimental to this goal.

18B. A German Perspective

BERTOLD WAHLIG

The question of which institution of a country should be assigned responsibility for banking supervision is ultimately not a legal question that can be answered in accordance with generally applicable legal principles. It is rather a question of the specific configuration of the public sector, in reply to which, at best, legal policy comments can be made, and these only with due caution, for every country has its own homegrown structures, its own constitutional conditions, and its own administrative culture.

Therefore, this chapter first emphasizes some general aspects that may be of significance for the organization of banking supervision. It defines the objectives of banking supervision and compares these with the goals of monetary policy and the tasks of central banks. Second, it addresses the question of whether central banks may be exposed to conflicts if they are ultimately responsible for banking supervision, and what it means if central banks are to serve as "lenders of last resort." Finally, this chapter describes the system of banking supervision in Germany and explains the interaction between the Federal Banking Supervisory Office, which has been assigned responsibility for banking supervision, and the Deutsche Bundesbank, which is extensively involved in banking supervision in practice.

Banking Supervision

The supervisory systems of the individual countries depend on the institutional frameworks, which differ considerably across countries and are based on the particular political, legal, and administrative traditions of the countries; their varying banking structures; and their differing approaches to the theory and practice of banking supervision.[1] The institutional framework largely depends on the reason for which banking supervision was introduced. The global economic crisis and the number of bank failures at the beginning of the 1930s triggered a concern in many countries about the particular susceptibility of the banking system to disturbances, along with an awareness of the necessity of depositor protection. Comprehensive supervision systems were set up in some countries, including Germany, at that time.

The creation of these systems was in some cases subject to considerable time pressure; in view of the urgency of the measures, there was often not enough time for basic preliminary discussions of the systematic questions

associated with the introduction of banking supervision. Initially, the national banking supervision systems—and the underlying supervisory concepts—were determined by the structural aspects of the national financial systems and the particular objectives of banking regulation.

This originally purely national orientation of banking supervision has long since been superseded: the internationalization of the banking business, the globalization of the markets, and the free movement of capital flows after the Second World War have increasingly sharpened the awareness of the need for close cooperation among national banking supervisory authorities and led to a closer material coordination of the various banking supervision systems. The most important role in coordinating the banking supervision systems was assumed by the Basle Committee on Banking Supervision, whose recommendations have set international standards for banking supervision beyond the range of its member countries.[2] In the European Community, Council directives have led to an intensive process of harmonizing the material banking supervision legislation of the member states, in order to achieve the European Community's objective of creating a single market for financial services by abolishing restrictions on freedom of establishment and freedom of services.[3]

"Introduction of supervision on a consolidated basis," "harmonization of bank accounting and valuation regulations," and "standardization of the capital requirements for credit institutions and definition of common criteria for assessing their solvency" are key words characterizing the intensity of the harmonization process in the European Community. In all bodies dealing with the harmonization of banking supervision and the international cooperation of banking supervisory authorities, the question has occasionally been raised of whether banking supervision should be carried out by the central bank or by an independent agency.

The advantages and disadvantages of supervision by the central bank have been discussed in individual countries, too. Rinaldo Pecchioli reports, for instance, on the discussion in Australia, in which it was assumed that the tasks of the central bank in the field of banking supervision may well clash with its monetary policy functions.[4] Nevertheless, the responsible body (the Campbell Committee) came to the conclusion that the necessary coordination of these two ranges of responsibilities could best be achieved within a single institution. Conversely, as Mr. Pecchioli reports further, a study group commissioned to amend Swiss banking legislation argued against assigning supervisory functions to the national bank, as the different tasks of banking supervision and monetary policy should be reflected in, among other things, a clear separation of the bodies responsible for them.[5] Apparently, none of the international bodies dealing with banking supervision have gained absolute

certainty about the advantages of one solution or the other, or given any general recommendations as to which agency should be assigned responsibility for banking supervision.

It is useful to compare the objectives and tasks of banking supervision, on the one hand, and the goals of monetary policy and the resulting functions of the central banks, on the other.

Objectives of Banking Supervision

It is widely agreed that banking supervision must ensure the general order of the banking system; maintain the banking system's ability to function; and protect the credit institutions' creditors against losses as far as possible.

At least in countries organized along market economy lines, the tasks of banking supervision can be reconciled with those principles. What is necessary is a synthesis of the basic freedom to make business policy decisions and conduct individual banking transactions or financial services, on the one hand, and the control of these activities through general regulations, requirements of disclosure to supervisory authorities, and mechanisms for intervention by these authorities, on the other hand. This synthesis must lend itself to application whenever an individual institution, a group of institutions, or even the entire banking system—including all financial institutions—is perceived to be threatened or in difficulty.[6] Furthermore, the synthesis should confirm that the responsibility for business decisions rests with the credit institutions' managers. The activity of credit institutions is restricted only by quantitative general provisions and their obligation to open their books to the supervisory authorities, who do not intervene directly in the credit institutions' individual operations. Only if the fulfillment of a credit institution's obligations to its creditors, and especially the safety of the assets entrusted to it, is endangered should the supervisory authority be empowered to take general measures to avert the danger.

The protective purpose and the main goal of banking supervision are to ensure the functioning of the banking system in the interest of creditor protection; it cannot be understood to be a direct government guarantee in favor of the individual creditor. For this reason, banking supervision as such is supplemented in many countries by deposit guarantee schemes in favor of the depositors.[7]

The question of whether the individual depositor benefits directly from banking supervision by being able to seek redress from the government for losses incurred through a failure of banking supervision was examined

by the German courts during the 1970s—among other things, as a consequence of the failure of the Herstatt Bank in Cologne. In two 1979 rulings, the Federal Court of Justice, the supreme court for civil law disputes, unexpectedly took the view that in certain circumstances the Federal Banking Supervisory Office has as part of banking supervision the official duty, vis-à-vis an individual third party, to take specific measures to protect depositors if it becomes aware of particular risks.[8] To avoid unforeseeable liability risks in the context of individual protection so construed, an amendment was added in 1985 to the Banking Act, stating that "the Federal Banking Supervisory Office performs its functions . . . in the public interest only."[9] Accordingly, the general principle that the establishment of public banking supervision does not simultaneously imply the establishment of a deposit insurance scheme applies again in Germany, as elsewhere.

In contrast to banking supervision relating to individual institutions, which is sometimes termed "microeconomic supervision,"[10] the central banks are responsible for the "macroeconomic" regulation of the total amount of money in circulation and the banking system's lending potential, with the aim of safeguarding the stability of the currency concerned. According to Section 3 of the Bundesbank Act, for example, the Deutsche Bundesbank is obliged, using the monetary powers conferred on it, to regulate the amount of money in circulation and of credit supplied to the economy, with the aim of safeguarding the currency.[11] Moreover, Article 105(1) of the Treaty Establishing the European Community, as amended at Maastricht,[12] describes the functions of the European System of Central Banks (ESCB) as follows:

> The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2. The ESCB shall act in accordance with the principle of an open market economy with free competition, favoring an efficient allocation of resources, and in compliance with the principles set out in Article 3a.[13]

Goal of Monetary Policy

As just outlined, the objectives of banking supervision as part of public regulatory policy are not identical with those of a central bank responsible for monetary policy, although there are major points of similarity. In the banking field, monetary policy and regulatory aspects are often interlinked. Measures taken by banking supervisors may have an impact on the control of the money supply by the central bank. For instance, the raising under banking supervisory aspects of the capital and liquidity

ratios of financial institutions to keep the institutions sound and to protect their creditors will at the same time affect the overall lending potential of the banking system, the control of which is the core of the central bank's function. However, monetary policy measures taken by the central bank may affect the status of individual credit institutions in a way that is significant for banking supervision. An increase in the minimum reserves by the central bank may impair credit institutions' liquidity and subject individual institutions to considerable tension.

These few examples show that it may be problematical to make the central bank alone responsible for banking supervision. This inference applies all the more as, judging by past experience, banking supervision is particularly required in the case of crisis management. A central bank with sole responsibility for banking supervision may come under pressure from public opinion or politicians and feel obliged to grant sizable liquidity assistance, which would not be appropriate in macroeconomic terms, given its responsibility to safeguard the currency.

Central Bank as Lender of Last Resort

The next question is, How is a central bank's role as lender of last resort to be defined in this context? This is not a legal question. Thomas Humphrey defines the term "lender of last resort" as referring "to the central bank's responsibility to accommodate demands for high-powered money in times of crisis, thus preventing panic-induced contractions of the money stock."[14] Ultimately, central banks are the only sources of liquidity available in unlimited quantities; therefore, their assistance is required in crisis situations.

It is not the task of legal experts to lay down how far the functions of a lender of last resort should go. As far as the granting of liquidity assistance is concerned, a distinction must no doubt be made between providing assistance to banks that are basically sound and to those that face severe liquidity and solvency problems of their own making. In the first case, temporary liquidity assistance by the central bank that is justifiable in macroeconomic terms will tend to be appropriate to avoid a crisis of confidence for the entire banking market, provided that the bank in difficulty has sufficient assets to serve as collateral for the central bank. In the second case, however, liquidity assistance is problematical if the bank concerned has lost its capital as a result of business losses and is unable to provide collateral.

If a central bank is ultimately responsible for banking supervision, there may be conflicting interests under the aspects of banking supervision, on the one hand, and monetary policy responsibility, on the other. The key

words "too big to fail" and "moral hazard" outline the difficulties. H.J. Muller describes the problem as follows: "The sure knowledge that, in the case of a failure, the public authorities will come to the rescue, could well lead to imprudence on the part of banks and creditors."[15] In an international context, this aspect is reflected in the deliberate vagueness of a 1974 statement by the Group of Ten countries:

> The Governors also had an exchange of views on the problem of the lender of last resort in the Euromarkets. They recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary. . . .[16]

U.S. economist Frederic S. Mishkin, speaking on the avoidance of crises in the international financial system, outlined the German point of view: "Some central banks, such as the Deutsche Bundesbank, object to having a direct regulatory role because they believe that it will subject them to political pressures which may interfere with their ability to use monetary policy to combat inflation."[17]

If there are some reservations in respect of assigning the sole responsibility for banking supervision to the central bank, there are also many good reasons for involving the central bank in banking supervision and, particularly, for establishing an exchange of information between the authority responsible for banking supervision and the central bank. Whether this authority is to be the ministry of finance or an independent agency is not significant; the choice of the responsible agency will depend on the framework defined by the constitution of a country for its administrative organization.

The interaction mentioned previously between measures by the central bank to control the money supply and measures or regulations by banking supervisors to observe specific capital or liquidity ratios necessitates cooperation between banking supervisors and monetary policymakers. It is ultimately in the interests of the credit institutions concerned that the central bank and the banking supervisory authority obtain the information and data required for their respective monetary or prudential purposes in a joint effort, if possible, to avoid duplication of work. In this sense, at least, the question "Who should be the banking supervisors?" could be answered "the ministry of finance or an independent agency plus the central bank."

System of Banking Supervision in Germany

In Germany, the concept of banking supervision is implemented through an independent supervisory authority that cooperates with the

central bank. This section explains briefly how this cooperation is regulated by law and how it works in practice.

General banking supervision in Germany is a consequence of the banking crisis of 1931. Although the idea of general banking supervision was discussed as early as 1874, in the context of the Act on the Establishment of the Reichsbank,[18] it was not pursued further, particularly in view of the reluctance to reimpose restrictions on the general freedom of trade following their abolition only a few years previously. On account of the extraordinary disruptions triggered by the banking crisis throughout the entire economic system, a Reich Commissioner for Banking was appointed in 1931 as an executive arm of banking supervision. A second banking supervisory agency, the Board for Banking, was also established as a coordinating body between the Government and the Reichsbank. After the Second World War, the Länder governments were initially responsible for banking supervision.

Since 1961, banking supervision has been carried out by the Federal Banking Supervisory Office, working in cooperation with the Deutsche Bundesbank. The Banking Act assigns the central role in banking supervision to the Federal Banking Supervisory Office,[19] which reports directly to the Federal Minister of Finance.

Recognizing that the functions of the authority responsible for banking supervision and those of the central bank are interconnected, the legislature has provided for the Deutsche Bundesbank to be involved in banking supervision.[20] Moreover, the participation of the Bundesbank is necessary because the Federal Banking Supervisory Office has no substructure of its own. It is only the Bundesbank system, with its main and branch offices, that permits efficient and cost-effective supervision at the local level of the over 4,000 credit institutions in Germany.

Banking supervisory functions are clearly divided between the Federal Banking Supervisory Office and the Bundesbank. First, sovereign functions, for example, the issuing of administrative acts, are the responsibility of the Federal Banking Supervisory Office. Second, before issuing general regulations, the Federal Banking Supervisory Office must confer with the Bundesbank.[21] The degree to which the Bundesbank is entitled to participate is graduated according to the extent to which the regulations affect its functions. Thus, when issuing principles concerning capital and liquidity, the Federal Banking Supervisory Office is required to reach agreement with the Bundesbank[22] while, in other cases, the Bundesbank has merely to be consulted. Third, the Bundesbank is fully involved in the regular surveillance of the credit institutions; it also analyzes the annual reports and other documents of these institutions. Observations that the Bundesbank makes in the course of these activities

are also used in the monitoring operations. Fourth, the Bundesbank maintains the credit register of loans of DM 3 million or more,[23] which is an important source of information both for the banking supervisory authorities and for lenders. This clause stipulates that credit institutions and insurance enterprises must report loans of DM 3 million or more to the Bundesbank, which adds together the loans to individual borrowers and subsequently notifies the lenders of the total indebtedness of their borrowers and the number of lenders involved.[24] Finally, to enable the banking supervisory authorities to analyze regularly the credit institutions' business, the latter have to submit monthly returns to the Bundesbank. The Bundesbank passes on these returns and provides its comments to the Federal Banking Supervisory Office. If the Bundesbank collects monthly balance sheet statistics for its monetary analysis, these are considered to be monthly returns, in order to avoid duplication of work by the credit institutions.

In 1993, the Bundesbank received, among other things, over 2 million reports on loans of DM 3 million or more pursuant to Section 14 of the Banking Act, and 50,000 monthly returns pursuant to Section 25 of the Banking Act.[25] The Bundesbank clearly obtains a great many prudential data that are at the same time useful for fulfilling its monetary policy functions.

Conclusion

It is important to mention the role of the future European Central Bank (ECB) in banking supervision. The ECB will not take over responsibility for banking supervision from the national authorities, but it will support the responsible agencies in carrying out banking supervision. Article 105(5) and (6) of the Treaty Establishing the European Community state in this respect:

> The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.
>
> The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.[26]

During the preliminary work on the statute establishing the ECB, there was an exchange of opinions in the Committee of Central Bank Governors on the degree to which the ECB should be involved in coordinating banking supervision. A common starting point for the govern-

ments concerned was, in view of the subsidiarity principle, to leave responsibility for banking supervision with the national agencies. The German side, in addition, held that a separation of supervisory responsibilities from monetary policy was appropriate. Not least for that reason, the assignment of further prudential supervision tasks pursuant to Article 105(6) is subject to the proviso of a unanimous Council decision.

18C. A Swedish Perspective

ROBERT SPARVE

Introduction

A glance at the institutional organization of banking supervision in a number of countries demonstrates the different solutions that have been found. There seems to be no uniform international trend, even though an endeavor to concentrate and to coordinate supervision may be observed in most countries.

Two major models may be noted. In many countries, banking supervision is conducted by the central bank (the central bank model), while such functions in other countries have been entrusted to an authority separate from the central bank, either to a division of the ministry of finance or a supervisory authority under the government (the alternative model).

One might expect that the choice of a model should be based on lengthy analyses or deliberations. However, this does not seem to be the case. Instead, the choice of model may often be explained by historical traditions. In Sweden, for example, the central bank has been under the authority of the Parliament rather than the Government since its establishment as the world's oldest central (banknote-issuing) bank in 1668. The predecessor of the central bank had gone bankrupt, and the Parliament decided to take over the bank in order to prevent the King from exercising the power to print money and thus maintain control of Sweden's military. During its first years, the central bank was simply called the Bank, because it was in fact for many years the only bank in Sweden. New, privately owned banks emerged in the mid-nineteenth century, for which bank licenses were granted by the Government. As the privately owned banks at that time also had the right to issue banknotes, and as the central bank competed with those banks in many areas, the issuance of bank licenses was made a government, rather than a central bank, task. It was, therefore, only natural that banking supervision was from its very start a duty to be performed by the Ministry of Finance and not the central bank. Later in the nineteenth century, the position of Bank Inspector and the Bank Inspection Supervisory Board were established. Another such board was established to supervise insurance companies.

In recent years, the question of responsibility for banking supervision has been deliberated by government committees in Sweden, as well as in

some other Northern European countries using alternative models similar to Sweden's.

As a starting point for this discussion, a survey of the current situation in some members of the Organization for Economic Cooperation and Development is helpful. (Additional information on banking supervisory and regulatory practices on the Group of Seven industrial countries can be found in Chapter 17B.) Some arguments that have been made in the Nordic countries for and against the central bank model are also addressed in this chapter.

Organization of Banking Supervision

Different countries have chosen different approaches to organizing supervision. The main determining factor seems to be the history and structure of the particular country's banking system and the prevailing view of the central bank's mandate.

The United States is perhaps the most obvious example. A large number of laws, for example, the Glass-Steagall Act[1] and the laws that prevented interstate banking, led to the development of a complex banking structure. This structure is reflected in the supervisory system, where, as has been detailed in Chapter 12 and Chapter 17B of this volume, no less than five different authorities, including the Federal Reserve Board, have supervisory responsibilities. The United States has thus chosen both the central bank and the alternative models. However, the organization of supervision in the United States is under more or less constant debate and has been criticized for being overly burdensome to the banks, partly because of overlapping responsibilities among the supervisory authorities. Recently, a proposal was put forward in Congress suggesting that supervision be concentrated in fewer authorities while excluding the Federal Reserve Board from direct supervisory responsibilities.[2] The Federal Reserve Board strongly opposed this proposal; most of its arguments for central bank involvement are addressed later in this chapter. The main argument is that the Federal Reserve Board needs the information and experience gained from its supervisory contacts with the banks to perform its other duties, such as conducting monetary policy.

In the United Kingdom, supervision rests with a separate division within the Bank of England. Since London is a central marketplace for banks, domestic as well as foreign, the Supervision Division employs a large staff and forms an important part of the central bank. In England, also, the organization of supervision has been debated, not least in the aftermath of the incident involving the Bank of Credit and Commerce International (BCCI). An argument put forward against central bank supervision was

that unsuccessful supervision might harm the general credibility of the central bank and thus impair its ability to perform its other duties, such as implementing monetary policy. There was a fear that the handling of the BCCI failure partly would be blamed on the Bank of England—which it was—and that this would have contagious effects on the Bank's credibility in performing other central bank activities. The investigation following the BCCI collapse did not find that supervision should be moved out of the Bank of England; however, the investigation suggested a number of measures to strengthen the organization of supervision, including through closer cooperation with other domestic and international authorities.[3]

In Japan, the main formal supervisory responsibilities lie with the Ministry of Finance, which cooperates closely with the Bank of Japan. Local authorities are sometimes also involved.

In Germany, as explained in Chapter 18B, the Federal Banking Supervisory Office, under the Ministry of Finance, has the primary formal role in supervision. As in Japan, however, constant and close contacts are maintained with the central bank.

In France, supervision is performed by the Banking Commission, a separate authority. The board of the Banking Commission is chaired by the Bank of France, but it also has board members from the Treasury and from other sources, such as court judges and independent experts. However, the Banking Commission's authority is closely linked with the Bank of France; it uses the central bank staff as a secretariat for its activities, including the examination of banks. Moreover, the head of the Banking Commission has the status of a director of the central bank. The structure of banking supervision in France is examined in detail in Chapter 18D. The organization of this supervision was recently debated in connection with the general discussion on the independence of the central bank. The prevailing organization was more or less upheld, as it was deemed that the existing setup provided a well-functioning balance between the Ministry of Finance and the central bank.

In Italy, the central bank, the Bank of Italy, has the formal supervisory power.

In the Netherlands, the integration of supervision in the central bank is complete. The supervisory division within the central bank is one of the three main pillars of the bank, and the executive director of the division has a seat on the central bank's board.[4]

In contrast to the situation in the Netherlands, the Office of the Superintendent of Financial Institutions in Canada has, under the aegis of the Ministry of Finance,[5] the formal mandate to perform supervision.

However, through the Financial Institutions Supervisory Committee and its Senior Advisory Committee, on which the Bank of Canada is represented, the central bank can influence practical supervision, regulation, and other overriding supervisory issues. In Canada, supervision is not directly under the central bank for historical reasons; the first supervisory authority was established even before there was a central bank.

In Sweden, Norway, and Denmark, the present situation, in which banking supervision is conducted by authorities separate from the central banks, has been deemed after public debate not to require any institutional alteration. Although these countries have thus decided to stick to their traditional alternative models, a number of measures have been proposed in Norway and Sweden to improve banking supervision. The same is true in Denmark, where the banking supervisory authority already works closely with the central bank. In Finland, however, a different conclusion has been drawn. There, it has been considered necessary to make the central bank the banking supervisor, mainly because of the need to involve the experts of the central bank more deeply in supervisory issues.

Although some arguments behind the approaches chosen in the Nordic countries will be addressed in detail subsequently, one rather unique and useful common aspect deserves immediate attention. The amalgamation of bank supervision and the supervision of other financial institutions, such as finance companies, insurance companies, and securities firms and markets,[6] has improved supervision—for example, by facilitating the exchange of information among supervisors of different market segments. This fusion of powers also facilitates the supervision of financial conglomerates. It is difficult to tell whether such amalgamation is better suited to the central bank or the alternative approach to supervision. Maybe one could say that, at least so far, the activities of insurance companies and securities firms have not been found vital for the functioning of the payments system and the monitoring of these institutions has therefore not been a priority task for the central banks. However, the activities and roles of different categories of financial institutions are becoming increasingly blurred, and central banks may well have to take a greater interest in the activities of institutions other than banks to achieve their overriding aim of securing the stability of the payments system.

A few conclusions can be drawn from this admittedly unscientific survey of the organization of supervision in a number of countries. First, different approaches have been chosen following one of the two main models—the central bank or the alternative. Second, in all countries where the main responsibility for supervision stays outside the central banks, there are close exchanges of information and cooperation between the two authorities. Third, in those countries whose supervisory struc-

tures have recently been reorganized, the tendency has been to move supervision closer to the central banks.

Advantages and Disadvantages of the Central Bank Model

The issue of transferring banking supervision from a separate authority to the central bank has been discussed in recent years in some Northern European countries. In Denmark, Finland, and Norway, banking supervision had been organized in the same way as in Sweden, that is, it had been performed outside the central bank by a separate authority. Mainly as a result of the recent financial crisis, which produced heavy bank credit losses in Finland, Norway, and Sweden, the organization and performance of banking supervision has been the subject of official reports and, later, decisions by governments and parliaments in these three countries. In Denmark, the issue has attracted less interest, and no institutional amendment has been decided. Banking supervision is still performed in that country by an authority separate from the central bank—perhaps because the extent of the bank failure in Denmark has been less dramatic than in the other Nordic countries. Also, the Danish central bank and the supervisory authority seem to cooperate smoothly.

Some of the main arguments that have been put forward during the discussions in Finland, Norway, and Sweden are addressed in turn.

Arguments for the Central Bank Model

The main argument in all three countries for making the central bank the banking supervisor is obvious. As the central bank is ultimately responsible for the payments system and the stability of the financial system—and is also the lender of last resort—the central bank should also be the banking supervisor. To split resources between two or more entities would be ineffective and risk the maintenance of unnecessary bureaucracy. If banking supervision were to be administered outside the central bank, the central bank would still have to monitor the banks as a consequence of its responsibility for the payments system and the stability of the financial system.

Inasmuch as it lends credits intraday and overnight through its payments system and as the main creditor to banks, the central bank must "know its customers." Most central banks have highly qualified and experienced staffs to analyze the performance of banks. Their staffs are also trained to understand banking risks and the implications of new systems and new financial products.

As central banks are also the main participants in the domestic money and foreign exchange markets, their staffs include experts in the functioning of these markets. It is particularly noteworthy that central banks continuously receive confidential information from other participants in the markets, who regard the central banks as objective "watchdogs."

Concentration of banking supervision in the central bank would thus more effectively use the available resources. Concentration would also reduce the risk of overlapping supervision by two or more authorities; on the other side of the coin, it would reduce the risk of inadequate supervision in some areas. If two or more entities were to supervise banks, there are obvious risks that some areas would be double-checked while others might fall between the competencies of the entities involved.

Concentration of supervision in the central bank would also represent important advantages from the perspective of the banks. Because the central bank needs the information anyway, it would minimize the need to supply more or less the same information to more than one authority. If possible, the authorities should make every effort to reduce the costs of those supplying requested information. Studies, including those done in the United States, have shown that the actual cost to banks of fulfilling their duties in relation to supervision and regulation is significant.

Among the other arguments for the central bank model put forward in the Nordic countries, the importance of the international perspective should be emphasized. The markets are growing every day and becoming increasingly global and interlinked. With modern technology, an event (or even a nonevent, like a mere rumor) in one marketplace is immediately made known around the world and may have dramatic repercussions in all financial markets. Banks are expanding by forming branches and subsidiaries in other countries. This development represents new challenges to all banking supervisors. Banking supervision has to become international: it can no longer limit itself to activities within national borders. In Europe, this is particularly obvious, as any bank within the European Economic Area (which comprises the member states of the European Community and the European Free Trade Association) with a banking license obtained in any of those countries may, without further licensing, conduct banking in any other country, either directly from the home country or through branches or subsidiaries in the host country.[7] The banking supervisors in the European Economic Area are, therefore, making cooperation agreements among themselves in order to facilitate the exchange of information and to promote more efficient cross-border banking supervision. Interestingly, in many European Union countries, the central bank is responsible for important parts of

supervision, especially of banks. Similar arrangements in other countries would facilitate international cooperation.

The need for closer international cooperation is an important argument to concentrate supervision in the central bank. Central banks have long been conducting close relationships with other central banks, for example, at the Bank for International Settlements. Supervision often comprises confidential matters. Because central banks have a tradition of trusting each other with such information, it may be deemed appropriate to vest banking supervisory authority in them.

Lastly, the importance for the banking supervisor of having access to the macroeconomic analysis resources of the central bank should be stressed. The need for such resources may be satisfied through close cooperation with the central bank, but the central bank may just as easily function as the banking supervisor.

Arguments Against the Central Bank Model

After considering the arguments in favor of the central bank as banking supervisor, what could be argued against it? Why would it be preferred to have an arrangement whereby a separate supervisory authority or a division of the ministry of finance is entrusted with the task of monitoring banks as the main banking supervisor?

One argument is the difficulty or undesirability of separating banking supervision from the supervision of other credit and financial institutions and financial markets. As previously noted, these categories may no longer be as clearly defined as they used to be. Other institutions are entering the traditional banking areas while banks are expanding outside their traditional activities. An illustration is useful. Insurance companies in competition with banks and mutual funds are constantly developing new products to attract investors. Some of these products are very similar to traditional bank products; for instance, insurance companies are expanding their lending activities in many countries and offering long-term credits to the public. Banks, meanwhile, are responding by creating new products to compete with the insurance companies. In Sweden, for example, banks are now allowed to sell to the public insurance policies, so-called unit-link insurance. Another new feature is that banks may own finance companies (and vice versa) and that such groups may in some countries be owned, in turn, by holding companies. These financial conglomerates may include stockbrokers, finance companies, and mortgage-lending institutions.

To the supervisors, these new developments imply the need to adapt and to cooperate more closely with one another. It would be desirable for

these reasons to concentrate all financial supervision in a single body. One alternative would be to make the central bank the sole financial supervisor. In no European country, however, is the central bank the supervisor of all financial institutions, including insurance companies. Furthermore, it would be outside its usual mandate for a central bank to cover all areas and aspects of the financial sector. It could, therefore, be argued that the other alternative—establishing a supervisory authority outside the central bank that is concerned with all financial institutions—seems more natural.

Another argument against the central bank model is the risk of conflict of interest that such a model may produce within the central bank. According to this argument, such conflicts can occur if the central bank is entrusted with banking supervision, in addition to its monetary policy functions. The main creditor of the banks, which is one of its roles, and the main counterpart in money and foreign exchange market transactions, which is another of its roles, should not simultaneously be the banking supervisor. In the latter capacity, it will have access to information that is unavailable to the other creditors and counterparts of the banks.

This argument seems to have been deemed valid by some central banks that simultaneously function as banking supervisors. In the United Kingdom, Finland, and Iceland, where the central banks are the banking supervisors, this function is not entirely integrated with the other central bank functions. It is often administered separately from the other departments of the central bank, in particular from the monetary and foreign exchange department. The governor of the central bank may not ultimately be responsible for banking supervision, as this task is often laid upon a department director acting as head of banking supervision. However, it is essential for the banking supervisor to have access to macroeconomic expertise, and for the monetary and foreign exchange department to be informed by the banking supervisor of its findings. It has further been argued that concentration of supervisory powers in the central bank may make the central bank too powerful, particularly if it is completely independent from government control. This may lead to a situation in which banks hesitate to oppose a decision by the central bank by, for example, bringing the matter to a court of law.

The banking supervisor is in some countries also responsible for consumer protection issues. The unnaturalness of many central banks' assuming such responsibilities is another argument for making a separate entity the banking supervisor.

Lastly, the "contagion argument" put forward against central bank supervision in the United Kingdom should be noted again. If a central bank, whose main asset in executing monetary policy is its credibility, fails

to supervise banks successfully, its credibility and thus its ability to execute monetary policy may be damaged as well. A central bank's credibility when implementing monetary policy may consequently be harmed by possible banking supervision failures.

Conclusion

The above-mentioned examples of views for and against the central bank model demonstrate the variety of arguments that may be made concerning the subject.

The present institutional arrangements in most countries do not seem to be the result of careful considerations based on thorough analysis, but rather may be explained by historical traditions. If banking supervision works without any major problems, there is no real need to amend the competencies of the authorities, regardless of which model was chosen in the past. However, if a financial crisis occurs in a country (as occurred in Sweden, Finland, and Norway), it is only to be expected that existing supervisory arrangements, including the institutional organization of financial supervision, will be examined and subjected to public debate.

There is arguably, however, another reason for focusing on existing institutional arrangements. Traditionally, banking supervision consisted mainly of gathering necessary data from the banks, evaluating them against the criteria in laws and regulations, and expressing observations and criticisms where banks failed to comply. This description refers to the previous situation in Sweden, and, although slightly exaggerated, it may be valid as a description of practices in other countries. Banking supervision was mainly legal work, and most qualified managers were lawyers. However, the manner in which banking supervision was administered in the past was, as the ensuing bank problems clearly demonstrated, inadequate. Today, it is even less adequate.

The way in which modern legal provisions are formulated supports a less rigid role for supervision. Regulations concerning capital adequacy and risk-control requirements presuppose new ways of conducting banking supervision.

The principal aim of banking supervision is to contribute to the stability of the financial system. It is important for the banking supervisor to identify prevailing risks and take proper remedial action. The banking supervisor needs to understand the functioning of the markets, existing and future financial products, and current bank practices. Furthermore, the supervisor must be well-informed about each institution and understand fully the accounts, so as to be able to make proper analyses.

Another new feature in banking supervision in Sweden, which is valid also in other countries, is the need to ensure that a bank's management is well-informed of existing risks. A bank's information system should allow its management to discover continuously—without the assistance of the banking supervisor—possible threats to the financial stability of the institution. In the past, this has not always been the case; sometimes, the management has been surprised to find how vulnerable the bank was to certain events. Bank management lacked a proper information system and was unable to fully understand and evaluate the situation. However, information is not enough. In order to be able to prevent risks and to take proper remedial action, management should also have an adequate risk-management system, including risk control.

The foregoing considerations lead to the conclusion that the banking supervisory authority, whether within or outside the central bank, should be staffed not only by lawyers and chartered accountants but also to an increasing degree by qualified, experienced economists and even mathematicians who are experts in financial risks and their management. The banking supervisor should emphasize the economic and operational risks in the financial system and be less focused on the formal, legal aspects. Of course, fulfilling legal requirements is not unimportant; however, the banking supervisor should rather stress the importance of taking all necessary measures, including formal examinations, to increase the stability of the financial system.

In supervising banks, the functioning of the markets and of derivatives and other financial instruments, as well the macroeconomic prospects, should be given priority. Such priorities may, of course, be made within any organization of institutional arrangements. However, only the central bank, because of its other functions, thoroughly understands the functioning of the markets, the financial instruments, and the macroeconomic prospects—the prerequisites for effective banking supervision.

The central bank has, moreover, a unique understanding of the development of certain financial risks (including interest rate and foreign exchange risks), both domestic and foreign. If banking supervision is administered by an authority separate from the central bank, a close cooperation between the central bank and the supervisory authority will be absolutely necessary.

A closer cooperation between the banking supervisor and the central bank is also of vital importance to the central bank. The latter should have access to the information and analyses conducted by the banking supervisor in order to monitor the markets and its debtors. The central bank is, after all, the authority ultimately responsible for the stability of the financial system.

The following conclusions can be drawn. First, the choice of banking supervisor is not a crucial issue. What is important is that the supervisory authority be adequately staffed and have access to the central bank's expertise. Second, whatever the present arrangements in a country, there is no need to formulate an institutional amendment "just for the sake of it:" This change should be desirable for special reasons. Alternatively, banking supervision may be amended within the existing framework. Finally, if a country needs to build a new supervisory system, use of the central bank model is recommended. It is interesting to note that the central bank model has been chosen where new central banks are being established in the Baltic countries, Russia, and the other countries of the former Soviet Union. In most cases, the central bank model makes the most effective use of available resources.

18D. French Banking Supervision

JACQUES MILLERET

In France, the legal framework that deals with banking regulation and supervision is loi no. 84–46 du 24 janvier 1984 relative à l'activité et au contrôle des établissements de crédit (the January 24, 1984 Act).[1] This Act created regulatory and supervisory authorities comprising representatives of the Bank of France and the state for the French banking system. Loi no. 93.980 du 4 août 1993 relative au statut de la Banque de France et à l'activité et au contrôle des établissements de crédit (the August 4, 1993 Act),[2] which ensures the independence of the Bank of France in the accomplishment of certain tasks, does not fundamentally change this framework. Nevertheless, the August 4, 1993 Act gave rise to a discussion of the role of the Bank of France.

Regulatory and Supervisory Authorities Instituted by the January 24, 1984 Act

The January 24, 1984 Act separated the regulatory and supervision functions into four distinct institutions: the National Credit Council, the Banking Regulations Committee, the Credit Institutions Committee, and the Banking Commission.[3]

Authorities Charged with Formulating and Implementing the Rules Applying to Credit Institutions

National Credit Council

The National Credit Council has only a consultative role. Under Article 24 of the January 24, 1984 Act, the Council was consulted on major aspects of monetary and credit policy, but these functions were abolished in 1993.[4] Currently, it reviews the operating conditions of the banking and financial system.

The National Credit Council has 53 members. The Minister for Economic Affairs and Finance and the Governor of the Bank of France serve respectively as Chairman and Vice-Chairman. The Council members include representatives of the state and members of Parliament, along with representatives of sectors of economic activity, trade unions, and credit institutions.

Banking Regulations Committee

Activities. The January 24, 1984 Act instituted an authority in charge of regulating the whole banking industry. The Banking Regulations Committee is responsible for defining the general rules applicable to credit institutions.[5] In particular, it specifies the conditions for the exercise of banking activities (such as minimum capital requirements and rules on the establishment of branch networks), the conditions on which the credit institutions may take equity participations, the requirements for transactions (such as interest rates on deposits and rules on supplying information to borrowers), the prudential standards (including solvency and liquidity ratios), the chart of accounts, consolidation rules, and the disclosure of accounting documents and information to competent authorities and the public.[6] Until 1993, the Banking Regulations Committee was also responsible for establishing the instruments and rules of credit policy.[7]

Organization. The Banking Regulations Committee is chaired by the Minister for Economic Affairs and Finance, who casts a vote in case of a tie.[8] The Committee comprises the Governor of the Bank of France and four members appointed for three-year terms by a decree of the Minister for Economic Affairs and Finance: one representative of the credit institutions, one member from the trade unions representing the staff of the credit institutions, and two persons chosen for their competence.[9]

The Committee has no staff. The General Secretary is appointed by the Governor and the Minister for Economic Affairs and Finance. However, the regulations are prepared by the Ministry of the Economy and Finance (the Directorate of the Treasury) or by the departments of the Bank of France. After adoption by the Committee, the Minister for Economic Affairs and Finance must approve the rules, which are then published in the Official Gazette.[10]

Credit Institutions Committee

Activities. The Credit Institutions Committee is responsible for issuing the authorizations that credit institutions need to start business.[11] Before granting such authorizations, the Committee shall verify that the applicant meets the conditions enumerated in Articles 15, 16, and 17 of the January 24, 1984 Act, including

- appropriateness of the corporate legal form for the activities of a credit institution;
- compliance with the minimum capital requirement;

- the presence of at least two people to determine the effective management of the business; and
- the integrity and the experience of its managers.

These authorization criteria transpose the terms of the EC's First Banking Directive of December 12, 1977[12] into French law. The Committee must also approve significant alterations to an institution's situation, such as changes in controlling interest or the exceeding of important thresholds by certain shareholders.

Credit institutions. Credit institutions shall be authorized by the Credit Institutions Committee as banks, mutual or cooperative banks, savings institutions, municipal credit banks, financial companies, or specialized financial institutions.[13] These categories of credit institutions vary enormously in size. The two main categories are the banks and the mutual and cooperative banks.

Banks are authorized to perform all types of banking operations.[14] The January 24, 1984 Act gives a very broad definition of such operations, including receiving funds from the public, providing credit services, and managing means of payment and making them available to customers.[15]

The mutual or cooperative banks are also entitled to perform all types of banking transactions.[16] They differ from banks by reason of the cooperative nature of their bylaws and their federal structure. They are all affiliated with central organizations that represent their members to the supervisory authorities. Each central organization is responsible for ensuring cohesion within its network and the smooth operation of its members, and it takes all necessary measures in that respect, in particular to safeguard the liquidity and solvency of individual institutions and the network as a whole. The position of the mutual or cooperative banks within the French banking system is of great importance, as they grant about 27 percent of all loans.

The remaining categories of credit institutions are specialized. The main remaining category is that of financial companies. These companies are not authorized to receive funds or deposits from the public for periods of less than two years; they provide specific services, such as consumer and sales credit, real estate credit, leasing, factoring, and guarantees.

On December 31, 1992, there were 1,736 credit institutions and 419 banks in France. This number is higher in France than in other developed countries because of the broad definition of banking operations given by the January 24, 1984 Act.[17]

Organization. The Credit Institutions Committee comprises the Governor of the Bank of France as Chairman (able to cast a vote in case

of a tie), the Director of the Treasury, and four members appointed by a decree of the Minister for Economic Affairs and Finance (one representative of the credit institutions, one member from the trade unions representing the staff of the credit institutions, and two persons chosen for their competence).[18]

The Credit Institutions Committee has no staff. Its secretariat is provided by the Credit Institutions Department of the Bank of France and administered by a general secretary appointed by the Minister for Economic Affairs and Finance and the Governor. This task has been entrusted to the General Secretary of the Banking Regulations Committee.

The Director of the Treasury may request postponement of any decision of the Committee; the Governor shall in due course then arrange for further discussion of the matter.[19]

Government relations. The collegial structure of the Banking Regulations Committee and the Credit Institutions Committee makes it possible to involve not only the central bank but also the Ministry of the Economy and Finance, representatives of professional bodies, and outside experts in the regulatory decisions affecting the banking system. The Bank of France, in providing administrative staff and members for these bodies and in preparing the decisions that they take, plays an important role in regulating banking. However, the role of the Ministry of the Economy and Finance is also essential. Close collaboration between the Bank of France and the Ministry of the Economy and Finance is necessary for these committees to work smoothly.

Under French law, the two committees have no legal personality; they are administrative authorities. The rules of the Banking Regulations Committee and the decisions of the Credit Institutions Committee may be appealed to the administrative courts.[20] In these situations, the liability of the state can be engaged.

Supervisory Authority for Banking Activity: The Banking Commission

Organization

The Banking Commission includes the Governor of the Bank of France as Chairman, the Director of the Treasury, and four members appointed by a decree of the Minister for Economic Affairs and Finance for a period of six years. These four comprise a member of the Conseil d'Etat and a judge from the Cour de Cassation (the highest administrative and civil

jurisdictions, respectively, in France), and two members chosen for their competence in banking and financial matters.[21] In case of a tie, the Chairman casts the deciding vote.[22]

Like the Banking Regulations Committee and the Credit Institutions Committee, the Banking Commission has no legal personality. It is an administrative authority. However, when imposing a disciplinary sanction, the Banking Commission acts as an administrative jurisdiction. It has no staff. Under the January 24, 1984 Act, the Bank of France was entrusted by the Banking Commission with using its own central banking staff to organize data analysis and carry out inspection visits.[23] However, some changes occurred in 1993 with the modification of the statutes of the Bank of France.[24]

Activities

The Banking Commission is responsible for ensuring credit institutions' compliance with the legal and regulatory provisions applying to them, and for taking disciplinary action.[25] It also examines the way in which the credit institutions operate and monitors the soundness of their financial situation, ensuring that the rules of sound banking practice are observed.[26]

Supervision of credit institutions. The Banking Commission uses the following three supervisory procedures to ascertain credit institutions' compliance with the laws and regulations applying to them and to monitor their activities:

- examination of institutions' financial accounting and statutory statements;
- inspection visits to the institutions; and
- data analysis.[27]

The Banking Commission draws up a list of the documents and data to be submitted to it and determines their form and the filing dates.[28] It may also ask the credit institution to provide additional information, and it may ask to be sent the auditor's reports and, in general, all accounting documents.[29] Also, at the instigation of the Banking Regulations Committee, the Commission may be required to lay down procedures for the application of certain regulations. For this reason, the Banking Commission issues several instructions and circulars every year.

The Banking Commission oversees the application of regulatory provisions by credit institutions. It verifies that each institution observes the

prudential standards set by the Banking Regulations Committee, which can be explained as follows:

- The solvency ratio defines the relationship between own funds and assets, together with off-balance-sheet items, weighted by the credit risk that they entail. This ratio is a transposition of the European solvency ratio instituted by the Council directive of December 18, 1989.[30]
- Risk distribution rules, which occupy a prominent position in the regulatory system, require credit institutions to limit their exposure to a single beneficiary to 40 percent of their own funds. Moreover, the sum of exposure to beneficiaries having received loans exceeding 15 percent of own funds must not exceed eight times the own funds. A Council Directive on Large Exposures[31] will further tighten this regulation. In any case, the aim of diversifying risks is an essential prudential precaution. Experience shows that all of the difficulties encountered by credit institutions in recent years have involved an excessive concentration of risks.
- Regulations on exchange rate positions limit these positions to a portion of the credit institution's own funds; credit institutions must comply with a maximum ratio of 15 percent between their long- or short-term position in each foreign currency and their own funds. In addition, their aggregate short-term positions in all currencies must not exceed 40 percent of own funds.
- Liquidity ratios require credit institutions to measure their short-term maturity mismatch risks. They must show a liquidity ratio of at least 100 percent, the components of which are determined on the basis of the estimated degree of liquidity or payability of assets and liabilities.
- Own funds and long-term resources ratios require credit institutions to fund a minimum of 60 percent of their fixed or long-term assets, or those with a residual duration of more than five years, out of own funds or resources due in more than five years.

The Banking Commission is mandated to make inspection visits not only to supervise the credit institutions' compliance with professional regulations but also to scrutinize their operations, monitor their financial standing, and assess their respect for sound banking practice. For these checks, supervisory data analysis may be insufficient. An inspection visit to a credit institution covers a wider range and is comparable to an external audit that particularly emphasizes the prudential requirements, the quality of the risks, and the profitability of the institution.

Furthermore, compliance with prudential standards alone is not sufficient to protect institutions against all types of difficulty. Consequently, the supervisory authorities are increasingly emphasizing the need for institutions to develop effective internal control procedures.

In recent years, the banking industry has been reminded of this obligation in a number of regulatory texts concerning financial futures, foreign exchange operations, interbank market operations, and capital market operations giving rise to interest rate risk. Credit institutions are required to have in place a system of internal controls comprising a set of procedures designed to guarantee the quality of the information provided to shareholder bodies and external supervisors, as well as an internal control department responsible for verifying the effectiveness and coherence of these internal control systems.

One of the roles of the Banking Commission, on the occasion of the inspection visits, is to verify that these procedures are indeed appropriate to the needs of the institution. The Banking Commission also assesses the degree of independence of the internal control department from the departments and persons being controlled, its competence, and the quality of its results.

A credit institution is normally subject to inspection every four or five years. Inspections are more frequent, however, when the institution encounters endemic financial difficulties or does not observe prudential rules. In addition to the usual verifications, the Banking Commission has developed "thematic" inquiries to analyze specific operations or exposure to certain types of risks. For instance, examination of property risks and measures to fight money laundering have been issues for inquiries.

Inspection visits may be extended to cover a credit institution's subsidiaries, the legal entities controlling it directly or indirectly, and their subsidiaries. Since January 1993, in application of the Second Banking Directive,[32] inspection visits can also be extended to include the branches or subsidiaries that credit institutions incorporated under French law have set up in other member states of the European Union.

Treatment of individual difficulties. When needed, the Banking Commission can take preventive measures. When a credit institution is in breach of the rules of sound banking practice, the Banking Commission may issue a warning.[33] It may also issue an injunction calling upon a credit institution to take all necessary measures to restore or strengthen its financial equilibrium or rectify its management methods within a stipulated period.[34]

If a credit institution has contravened a law or regulation relating to its business, or if it has not complied with an injunction or ignored a warn-

ing, the Banking Commission may impose one of the following disciplinary sanctions: caution, reprimand, prohibition on the execution of certain operations, temporary suspension of the persons responsible for the effective management of the institution, compulsory suspension of those same persons, or withdrawal of the institution's authorization.[35] Furthermore, the Banking Commission is empowered to impose a fine not exceeding the minimum capital requirement and to appoint a provisional administrator.[36]

When imposing a disciplinary sanction, the Banking Commission acts as an administrative court;[37] such decisions can be appealed only to the Conseil d'Etat. In 1992, the Banking Commission issued 30 injunctions and 10 disciplinary procedures while imposing 3 withdrawals of authorizations.

A special mention should be made of Article 52 of the January 24, 1984 Act, which refers to a situation in which a credit institution is in danger of insolvency. In this case, the Governor of the Bank of France is enabled to call upon the shareholders to provide the institution with the support that it needs.[38] The Governor may also organize an industry-wide contribution on the part of all credit institutions to safeguard the interests of depositors and third parties, ensure the smooth functioning of the banking system, and preserve the reputation of the financial center.[39] This power is given to the Governor and not to the Banking Commission. The implementation of this procedure is justified only in exceptional situations, when the difficulties experienced by a credit institution entail a systemic risk. This procedure is not aimed at taking the place of the deposit insurance system, which is organized by the banking industry in France.

Exercise of other legal powers. The Banking Commission has three other tasks. First, it is responsible for enforcing compliance with the industry's rules of good conduct. Second, under the January 24, 1984 Act, the Commission has one month in which to contest proposed appointments by credit institutions of statutory auditors. Finally, several legislative and regulatory texts have been adopted recently to combat the laundering of money derived mainly from the drug trade. These regulations call on credit institutions to be vigilant at all times and require them to establish adequate internal structures and procedures to ensure compliance. They are notably required to adopt written internal rules, to be available for communication with the competent supervisory authority (the Banking Commission) at the latter's request, and to have a surveillance system capable of verifying compliance with internal procedures.

Independence Granted to the Bank of France by the August 4, 1993 Act

Reform of the Statutes of the Bank of France

The August 4, 1993 Act changed the statutes of the Bank of France in accordance with the provisions of the Maastricht Treaty.[40] The Act states that the Bank of France formulates and implements monetary policy with the aim of ensuring price stability.[41] It carries out these duties within the framework of the Government's overall economic policy, neither seeking nor accepting instructions from the Government or any other person in the performance of its duties.[42] This provision has been taken directly from Article 107 of the Treaty Establishing the European Community, as amended by the Maastricht Treaty.[43] Monetary policy is, however, the sole activity in which the Bank of France is wholly independent of the Government.

Within the Bank of France, there are now two governing bodies. Monetary policy is entrusted to an independent body, the Monetary Policy Council,[44] while all the other activities of the Bank of France are administered by a second body, the General Council.[45] A censor, appointed by the Minister for Economic Affairs and Finance, may oppose any decision taken by the General Council.[46]

Changes in the Bank of France's Relations Created by the January 24, 1984 Act

Although the August 4, 1993 Act was not meant to call into question the checks and balances resulting from the January 24, 1984 Act, granting autonomy to the Bank of France required changes in its relations with the regulatory and supervisory authorities created by the latter Act. The adjustments mainly concerned its relations with the Banking Regulations Committee and the Banking Commission.[47]

Banking Regulations Committee

The amendments to the provisions of the January 24, 1984 Act concerning the Banking Regulations Committee affect both its area of competence and its procedures.

The Banking Regulations Committee, which had previously been responsible for drawing up regulations concerning the instruments and rules of credit policy,[48] no longer does so, as no easy distinction can be

made between monetary policy, which is the preserve of the Bank of France, and credit policy.

Two aspects of the Banking Regulations Committee's procedures were modified. First, the position of Vice-Chairman of the Committee, which was filled by the Governor of the Bank of France under the terms of the January 24, 1984 Act,[49] was eliminated.[50] Consequently, the Governor of the Bank of France may no longer chair the Committee if the Minister of Economic Affairs and Finance is unable to attend. The Governor is still a member of the Committee.[51] Second, the Act states that the Minister for Economic Affairs and Finance, acting as Chairman of the Banking Regulations Committee, determines the terms and conditions for implementing the regulations that it issues.[52] Previously, the January 24, 1984 Act stated merely that the Bank of France and the Credit Institutions Committee were responsible, each in its own area of competence, for implementing the regulations issued by the Banking Regulations Committee.[53] Although this provision was not included in the new Act, it is probable that the authorities responsible for implementing the regulations issued by the Banking Regulations Committee will retain implicit powers to interpret them.

Banking Commission

The composition and the tasks of the Banking Commission are unchanged.

The August 4, 1993 Act recognizes the existence of the General Secretariat of the Banking Commission.[54] The General Secretariat was not mentioned in the January 24, 1984 Act, Article 39 of which stated that the Bank of France was responsible for arranging for its staff to carry out supervisory data analyses and inspection visits. The General Secretariat was formerly a department of the Bank of France; now, the General Secretariat of the Banking Commission—not the Bank of France—is responsible for carrying out supervisory data analyses and inspection visits.[55] The Bank of France is required merely to provide staff and resources, in accordance with terms and conditions to be specified in a formal agreement, to the General Secretariat, which may also call on outside persons.[56]

Nothing is said in the August 4, 1993 Act concerning the appointment of the General Secretary of the Banking Commission. A June 28, 1996 decree specifies that the General Secretary is to be appointed by the Minister of Finance at the proposal of the Governor. At the time of the publication of the decree, the Minister of Economic Affairs and Finance announced that the staff of the General Secretariat will be remunerated

by the state. The Bank of France, which is required by law to provide the General Secretariat with staff, will receive a remuneration for this service.

Conclusion

The Bank of France plays an essential role in banking regulation and supervision, although these functions are fulfilled by authorities that are distinct from the Bank of France. This role was not really changed by the August 4, 1993 Act. The balance between the Ministry for Economic Affairs and Finance and the Bank of France must be appropriate when the Bank of France becomes part of the European System of Central Banks under the terms of the Maastricht Treaty.

COMMENT

WILLIAM E. ALEXANDER

Banking Supervision Authority

When considering the question of who should be the banking supervisors, the first matter to be addressed is to ensure that all sides of the debate are equitably represented. In the majority of countries, the central bank is the banking supervisor (the "central bank model," as discussed in Chapter 18C), although the "alternative model" is the modus operandi in Germany and Sweden. In France, also, recent actions have tended to emphasize the alternative model, that is, separation—in theory, if not in practice—between the central bank, with independent powers to conduct monetary policy, and the banking supervisor. Canada also employs the alternative model.

Table 1 summarizes the supervisory arrangements in IMF member countries. In this table, countries following the alternative model are disaggregated into countries supervised by finance ministries and those having other arrangements. Notwithstanding the heavy representation of the alternative model in the discussion in Chapters 18A–D, a survey of members of the Organization for Economic Corporation and Development is consistent with the results for all IMF members in Table 1 confirming the preponderance of central bank supervisors. An important geographical factor that should be noted, however, is that the choice between central bank and alternative models is split evenly within the Western Hemisphere.

Second, although the observers in Chapters 18A–D largely focus on the central bank and alternative models, at least two other models may have some conceptual and empirical relevance. Both derive from the question, Is supervision necessary, and, if it is deemed to be so, must it be performed by the public sector?

In focusing on the two main alternatives, one may be inclined to assume that the answer to the first question posed should be in the affirmative. However, it is worth considering the second question—whether at least some of the inspection and supervisory functions could in principle be performed by the independent auditors of banks, assuming that they could be required to report their findings and concerns to the supervisory authority. Arguably, the public accounting firms that are appointed as shareholders' auditors are likely to have specialized expertise in assessing the suitability of internal systems for managing and controlling risk—

a task that has been identified as essential for supervisors to master. The availability of private sector expertise provides a possible supervisory alternative to the central bank (which itself may be unique among government agencies in possessing a level of expertise in this area). While there is an issue of whether a public auditor has sufficient independence from its client to perform this function effectively, the option seems worthy of consideration.

Table 1. Supervisory Arrangements in IMF Member Countries[1]

Region	Number of Countries in Region	Central Bank Supervision	Ministry of Finance Supervision	Other
Africa	42	41	0	1
Asia	30	25	3	2
Europe I	29	21	1	7
Former Soviet Union	15	15	0	0
Middle East	17	16	0	1
Western Hemisphere	34	17	3	14
All members	167	135	7	25

[1] Jose Tuya & Lorena Zamalloa, *Issues on Placing Supervision in the Central Bank* (April 1994) (unpublished paper, International Monetary Fund).

The second part of the question raises the issue of whether public supervision is necessary at all. In theory, given adequate competition and financial transparency, suitable public disclosure, limited deposit insurance, and the clear unwillingness of the public sector to underwrite private sector risk, it may be argued that the market would be self-disciplining, and public supervision unnecessary. Some of these conditions are stringent, however, and in practice may be difficult to meet. Nevertheless, such thinking seems to underpin the new, more minimalist approach to supervision that is being considered in some countries, and it is worth considering whether this approach could be applied more widely.

Finally, it is noteworthy that the Monetary and Exchange Affairs Department of the IMF often recommends in its technical assistance that the supervisory function reside in the central bank. The three principal reasons for this recommendation are addressed in turn.

Recommendations in the Context of Overall Financial Sector Reform

First, in examining the experience in implementing financial sector reform in member countries, observers have noted that these reforms often fail because of inadequacies in the framework of financial supervision. Too often, these inadequacies become apparent only after the process of liberalization has begun. Typically, financial sector liberalization will involve the freeing of interest rates, the phasing out of various forms of directed lending or credit controls, and the intensification of competitive pressures (sometimes through the opening up of the domestic financial sector to foreign competition). In a situation in which banks and other financial institutions have to learn to function in the new environment—to evaluate and manage new risks, including credit and market risks—there is great potential for financial disaster and, therefore, a need for a strong and adaptable supervisory framework. Sometimes, too, the financial sector reform will start from a situation of financial distress, with weak or insolvent institutions that must be strengthened as part of the reform, and with public ownership of the banking system. In all these cases, the best results have generally been obtained when a strengthening of the supervisory framework—including establishing a degree of independence for the supervisor—is part of the overall reform. In practice, this usually means placing supervision within the central bank.

This experience is not restricted to developing country members of the IMF. When financial sectors are liberalized in the industrial countries, as occurred through the latter half of the 1980s, the result typically has been the (at least temporary) breakdown of the predictive power of monetary aggregates, rapid credit growth, and cycles of boom and bust in key asset prices, in addition to the weakening of the balance sheets of some financial institutions. The potential usefulness to the monetary authorities of access to bank-by-bank supervisory information for interpreting economic and financial developments during such periods thus makes a case for unifying banking supervision and monetary policy within the central bank.

Recent Focus on Countries of the Former Soviet Union

A second argument for placing banking supervisory powers within the central bank comes from the Baltic countries, Russia, and the other countries of the former Soviet Union, where there is an overwhelming need to develop expertise on a wide range of fronts simultaneously. The luxury of the possible duplication of resources, which might occur if central

banking and banking supervision were separated, is not available. In addition, the development of basic financial sector infrastructure, much of which is related to the supervisory function, is of paramount importance. Most notable in this respect is the need to create a viable payments system, which should be the responsibility of the central bank.

Supervision as an Important Dimension of Monetary Policy

Finally, a compelling argument has been made that the important macroeconomic dimension of supervision, which is associated with the need to contain systemic risk, is changing the techniques of supervision and shifting the skill mix away from a reliance primarily on legal and accounting knowledge to an emphasis on economics and mathematical expertise. The logical complement to this argument is the growing recognition that the effectiveness of monetary policy depends importantly on the health and competitiveness of its channel of transmission, the banking system. Indeed, monetary theory assumes the existence of such a condition and completely abstracts from the institutional environment in order to focus on macroeconomic variables, such as monetary aggregates, the level of interest rates, and the rate of price inflation.

But what happens when the banking system is fragile or even impaired? The experience of the past few years in many industrial countries strongly suggests that the implementation of monetary policy becomes highly problematic. At times, monetary policy is looser or tighter than anticipated, leading either to a rationing of credit resources for borrowers who rely heavily on the banking system (a "credit crunch"), a widening of intermediation spreads, or a reduced sensitivity of bank lending or deposit interest rates to attempts by the central bank to vary the central market rate of interest. In these circumstances, access to the expertise and knowledge of the supervisor becomes critical. This experience argues strongly for assigning banking supervisory responsibility to the central bank.

Chapter 19 BCCI: The Lessons for Banking Supervision

THOMAS C. BAXTER, JR.[1] AND JET JOSEPH DE SARAM

Introduction

In July 1991, a consortium of central banks, including the Federal Reserve, the Bank of England, and the Luxembourg Monetary Institute, coordinated the closing of a multinational bank known as the Bank of Credit and Commerce International (BCCI). The discovery of a massive and widespread fraud, perpetrated over several years, precipitated BCCI's closure. At the time of its closure, BCCI had become a truly global bank. The fact of its closure and the reasons for it provide a particularly graphic illustration of the special difficulties inherent in supervising complex multinational banks.

This chapter contains some views on the lessons that banking supervisors can learn from BCCI. It raises the following five questions that may be asked in the aftermath of BCCI: What happened? How did it happen? Why is what happened important to banking supervisors? What is being done to prevent a recurrence? What lessons can be learned from the failure of BCCI? Each section addresses one of these questions and provides answers that highlight some of the most important lessons.

What Happened?

In July 1991, when the public first learned of what would come to be known as the BCCI scandal, there was no benchmark for comparison. Although other multinational banks, such as Banco Ambrosiano, had failed, none had the complexity or geographic diversity of BCCI.[2] Furthermore, none had assumed the identity of a bank for the so-called developing world, as BCCI had. BCCI is the largest banking fraud in history, but to call it thus in view of these special characteristics almost minimizes its significance.

When BCCI closed, it boasted $23 billion in assets worldwide. It had a known presence of 380 offices in 72 countries, and a covert presence in others. Through a complex web of subsidiaries, affiliates, branches, and other entities, some secretly owned through nominees who acquired and

retained control for it, BCCI operated in these varied jurisdictions, including the United States.

Despite its complexity and geographic diversity, the consortium of central banks closed BCCI swiftly and surely, with no systemic effect on the financial system or the operation of the payments system. In large part, this achievement (there is some irony in claiming this as an achievement) is attributable to the careful coordination among the central banks of several nations.

Financial Costs

The losses stemming from BCCI's closure were enormous. At first estimated to range anywhere from $4 billion to $18 billion, the losses are known to be approximately $10 billion. Nationals from the so-called developing nations, who were attracted to BCCI for reasons to be explained later, bore the brunt of those losses. Many developing nations had placed large deposits of national reserves with BCCI, as had some prominent international organizations. Therefore, a particularly sad fact of BCCI's failure is that the bulk of its losses have been inflicted on populations and nations who were poorly situated to sustain them.

Human Costs

The existence of this human component means that the cost of BCCI cannot be measured only in money. Many individual victims of the bank's wrongdoing lost lifetime savings that they had entrusted to what they perceived as "their" bank. Among the hardest hit were members of certain immigrant communities, most visibly in the United Kingdom, on whom the bank's failure had a disproportionate impact. The people of these communities had been drawn to BCCI in the belief that the bank would be responsive to their special needs and situations.

When BCCI opened in 1972, it was staffed largely by South Asians who understood the religious traditions, culture, and customs of that region. For this reason, the large South Asian immigrant communities—in the United Kingdom, for example—found in BCCI a bank that literally spoke their language. Similarly, devout Muslims in several nations entrusted their wealth to BCCI because it promised to invest it in conformity with Islamic principles, which, among other things, forbid the charging of interest on loans and require that any return on funds employed by the lender be earned as profit derived from a commercial risk taken by the lender. To these people, the closure of BCCI represented not only a catastrophic financial loss but also almost certainly a sense of betrayal.

The impact on individuals was exacerbated in several countries where there is no system of deposit insurance or where the coverage provided is paltry. Depositors in these locations, in many cases, lost their personal savings. Small businesses that served these communities also suffered, some to the point of bankruptcy.

This chapter will later revisit the human aspect of BCCI's failure when it describes the ongoing effort to compensate BCCI's victims.

Other Nonfinancial Costs

Although the financial and human costs of BCCI's failure are staggering, there is more. The revelation of widespread corruption has led to a regrettable loss of faith in government and government organizations.

Corruption was an integral part of BCCI's criminal enterprise worldwide. In several countries, officials of governmental bodies, central bankers even, "buttered their bread" with BCCI offerings. They accepted bribes in return for various forms of official largesse, including privileged treatment, special dispositions, changes in legislation, and the placement of large deposits of national reserves with BCCI. Corruption was key to BCCI's rapid growth, and, in it, BCCI found a willing and able ally. Not surprisingly, public confidence in government has eroded in the wash of perceived corruption.

Because BCCI was seen as the bank for the so-called developing countries, some have claim regrettably that BCCI was wrongly closed by developed countries because BCCI had grown too big, too fast.

How Did It Happen?

All of this leads to the next question, How did it happen? There is no single method by which BCCI was able to accomplish its global scheme. Rather, several factors worked in synergistic tandem. These factors can be organized into the following six categories: (i) fractured supervision; (ii) irrational corporate organization; (iii) corporate culture; (iv) authority; (v) representation; and (vi) technology.

Fractured Supervision

The globalization of modern banking raises special concerns about which supervisory authority has control over a banking institution's international activities. Proper allocation of supervisory responsibility among the various national authorities is vital. Basic to this is the principle of consolidated supervision—that a single supervisory authority should

preside over the operations of a single financial organization, top to bottom, wherever those operations are conducted.[3]

Consolidated supervision provides a window on the overall condition of a financial organization, even one operating in multiple jurisdictions with differing laws and regulations. It also provides a method of determining the extent and lawfulness of an organization's worldwide operations.

The supervision of BCCI was fractured: no one country had a clear picture of BCCI's worldwide activities on a consolidated basis. This was no accident. To achieve this result, BCCI's organizers and operators carefully designed BCCI's structure to evade consolidated supervision, resorted to a covert presence in several juridictions, exploited the existence of secrecy laws, and manipulated the bank's audit process.

Structure of BCCI

BCCI's organizational structure was key to its avoiding consolidated supervision by any home country. The apex of the BCCI organization was the parent holding company, BCCI Holdings (Luxembourg) S.A., which was chartered and headquartered in Luxembourg. Below were two principal banking subsidiaries: BCCI S.A. and BCCI (Overseas) Limited. These were chartered in Luxembourg and the Cayman Islands, respectively.

Under Luxembourg law, the holding company was not subject to supervision. The Luxembourg bank (BCCI S.A.), which was subject to some supervision in its home country by the Luxembourg authorities, nonetheless conducted its principal operations in the United Kingdom. BCCI's other bank subsidiary (BCCI (Overseas) Limited) had its base in the Cayman Islands, where supervision was neither rigorous nor very effective. As a result of this structure, BCCI escaped effective consolidated supervision.

In sum, out of the 72 countries in which BCCI maintained offices and did business, no single supervisory authority had an unobstructed view of BCCI's entire landscape. Furthermore, because BCCI's operations spanned multiple jurisdictions, the supervisors in each assumed that the other would deal with BCCI's problems. In actuality, no one did.

In time, when BCCI's problems were too widespread to ignore, a group of countries with major BCCI operations agreed to meet periodically as a "college of supervisors" to monitor the affairs of the bank. Even under this arrangement, however, no single supervisor had overall responsibility for the organization's combined operations. Additionally, the

group's mandate did not allow it to provide the type of supervision needed by BCCI, and what supervision was provided was too little, too late.

Covert Presence

BCCI had another means for evading supervision: the operation of secret subsidiaries through nominees. BCCI used this technique in countries where supervision and regulation were more rigorous or where, for whatever reason, BCCI's presence was unwelcome. For example, in the United States, BCCI deliberately concealed its ownership and control of several financial institutions, including the First American group of banks. Because banking supervisory authorities in the United States were unaware of BCCI's ownership of these institutions, BCCI was able to evade their attention. Even if BCCI had a single supervisor—which it did not—the U.S. authorities would not have expected that supervisor to be interested in the operations of these banks because the U.S. authorities did not know that they were a part of the BCCI organization. This demonstrates an important concept for bank supervision, that nominee ownership defeats consolidated supervision. Furthermore, certain corporate structures that facilitate nominee ownership, such as bearer share companies, similarly frustrate consolidated supervision.

Secrecy Laws

Adequate consolidated supervision of a multinational bank such as BCCI requires a significant amount of cross-border information sharing among supervisors. Bank secrecy laws, however, substantially impede the dissemination of information. For example, they make it difficult for a home supervisor to secure from jurisdictions where subsidiaries operate the information needed to understand the condition of the consolidated entity. Furthermore, secrecy laws make the detection of fraudulent activity more difficult and impede its investigation and foreclose the timely initiation of enforcement proceedings or criminal prosecutions.

BCCI skillfully exploited the existence of secrecy laws in certain jurisdictions to conceal the criminal activities of parts of its organization from the authorities who were supervising them.

Auditing of BCCI's Global Operations

For most of its life, BCCI divided auditing responsibility for its global operations between two firms of auditors. One firm had responsibility for the Cayman bank; the other had responsibility for the Luxembourg bank.

Because no auditor monitored all of BCCI's global operations, BCCI was able to conceal its true condition.

BCCI derived an added benefit from having separate auditors for the two main divisions of its operations. Year-end audits were conducted at different times in the different locations, enabling BCCI to deceive each set of auditors. BCCI did this by booking loans in location X while location Y was being audited and using the proceeds of those loans to cover losses in Y. Later, when location X was being audited by another set of auditors and the loans scrutinized, the loans would be discharged or serviced with the proceeds of new loans in location Y. Because different auditors looked at different locations, this simple deception could be used—and was—to great effect. The manipulation of auditors enabled BCCI to escape adequate supervision of its operations.

Use of External Auditors

In some nations, supervisors rely on the reports of external auditing firms rather than on their own staffs of bank examiners. This practice exacerbated the effects of BCCI's fractured supervision. The use of external auditors makes it less likely that fraud detected in a financial institution will be reported to authorities. An external auditor is paid for its services by the management of the institution that is being audited. In such an arrangement, there exists an inherent conflict. If wrongdoing is reported and, as a result, management is replaced, the new management may prefer a new audit firm. Consequently, whistle-blowing by an auditor might well lead to loss of business for the audit firm. Furthermore, auditors are not accountable to anyone but the management of the organization that they are auditing. Auditors thus have no incentive to look more closely at the books than is necessary to file a favorable, or at least neutral, report. A "qualified" report might well result in the loss of millions of dollars in business for the organization.

Corporate Organization

BCCI's corporate organizational structure was tailor-made for its illegal activities. This organizational structure appears rational only if one assumes that the organization has an unlawful objective.

For example, in the Cayman Islands, BCCI had set up a structure at the local level that mirrored its global structure (see above). Why, in an area as small as the Cayman Islands, would BCCI require two banks? It was not as if a large number of island depositors were clamoring for BCCI's banking services; rather, it was booking loans on the books of BCCI, subject to the scrutiny of one set of auditors, and paying down

those loans with the proceeds of others on the books of BCCI (Overseas), subject to the scrutiny of another set of auditors.

In Luxembourg, too, BCCI's corporate organization served no apparent legitimate commercial purpose. There, BCCI established its flagship bank, BCCI S.A., as well as a branch of a Swiss banking institution that it controlled—Banque de Commerce et de Placements. Again, one wonders why BCCI needed to establish two banks in a location like Luxembourg. Surely BCCI was not seeking to serve the depositor community in Luxembourg.

In hindsight, it is clear that BCCI's unique structure had only an illegitimate purpose: it was set up deliberately to further its global criminal scheme undetected.

Corporate Culture

The term "corporate culture" is used here to mean several intangible factors that together played a significant part in ensuring the success of BCCI's criminal scheme. The founder and president of BCCI, Agha Hasan Abedi, was able to extract unquestioning loyalty and confidentiality within the bank because he exploited these factors in no small measure.

BCCI's corporate culture flourished in its so-called central support office. This support office was the operational center of the bank, located at 100 Leadenhall Street in London. The small band of executives working in the support office were all of South Asian origin. Recruited by BCCI's organizers, these executives had relocated to the United Kingdom to work for BCCI. In many cases, these expatriate bankers had also relocated their families to the United Kingdom and had established new roots in that country.

Throughout their tenure at BCCI, the executives at the central support office had been concerned with losing their jobs in London. If that had happened, they could no longer have continued to live with their families in their adopted country. These bankers also knew that, if they lost their positions at BCCI, they could not hope to match at any other institution the salaries that BCCI paid them. BCCI's executives were, therefore, absolutely dependent on the goodwill of BCCI's leader, Agha Hasan Abedi. If he were crossed, the penalty was certainly loss of livelihood and perhaps repatriation.

In addition to the economic disincentive to stray, Agha Hasan Abedi was able to create an almost blind faith among BCCI's staff. He did this by using his remarkable personal charisma and by emphasizing BCCI's

commitment to the Islamic religion and the important mission that it was engaged in as a bank for the developing world.

Authority

A unique characteristic of BCCI's corporate structure was that those individuals running the organization were difficult to identify. An observer could not tell that the bank's worldwide operations were being run out of the fourth floor of BCCI's London office.

Unlike other banks, which are run as hierarchies, BCCI was seemingly egalitarian. None of the officers had titles or rank; they were characterized by the same generic description, "executives." Moreover, these executives did not have private offices; their desks were arranged according to what was known in BCCI as the open plan, in a large, open space in the Leadenhall Street office in London.

As a result of this apparent egalitarianism, no one looking in from the outside could determine the source of authority. This arrangement was in stark contrast to most modern-style financial institutions, where the source of authority is clear from the individual's title and even from the location of that individual's office on the floor plan.

Instead of the usual trappings of authority, BCCI resorted to a simple legal device, the power of attorney. Each power of attorney identified the executives authorized to act for BCCI's various constituent banks, thus providing an easy way for a few individuals in the central support office to do whatever was necessary to keep BCCI afloat around the world. For example, if an auditor were questioning a loan that appeared to be past due at the Luxembourg bank, an executive in London could, by using a power of attorney, make loans on the books of the Cayman bank, transfer by wire the proceeds to the Luxembourg branch of the Swiss affiliate, and direct from there another wire transfer to the Luxembourg bank.

Representation

BCCI was able to deceive auditors and regulators around the world because it was represented by believable people and because it used credible nominees to hide its ownership of financial institutions. Representatives of BCCI were believed because of who they were and not because of the inherent truth, if any, in what they said. Usually, they were people with distinguished careers and impeccable reputations for integrity. Often, they had significant ties to the political establishments of their countries. The statements that they made on behalf of BCCI had an effect on regulators that those same statements would not have had if

BCCI itself had uttered them. It was no accident that BCCI retained people of such caliber; it understood that its representation would go unchallenged and used this to maximum advantage throughout the world.

In its nominees, too, BCCI chose well. They were credible people of enormous personal wealth who did not appear to be unlikely purchasers of a bank. These were conspicuously wealthy individuals, from prestigious families, who seemed to be the least likely to sell their names for a fee.

BCCI's representatives were also not above resorting to accusations that regulators in the developed nations were biased against "Third World" banking organizations. Consequently, regulators understandably sensitive to such accusations tended to be cautious in resisting BCCI's persistent efforts to penetrate their banking systems. BCCI was thus able to orchestrate its deception by skillfully manipulating the expectations and beliefs of the people with whom it dealt.

Technology

Finally, BCCI was able to sustain its global deception over time because the people who acted for BCCI understood how modern technology worked and used it to suit their purpose.

The central support office serves as an illustration of this point. From London, executives were able to operate banks around the world by using modern telecommunications equipment and funds transfer systems. Clearly, they understood the payments system and made it work for them, moving funds rapidly from location to location, as needed, to keep BCCI afloat.

BCCI was able to hide funding transactions between affiliates by using an intermediary financial institution that was willing to cooperate. The Banque de Commerce et de Placements, its Swiss affiliate, often performed this role. The intermediary bank would be asked to omit any reference to BCCI as the originating bank in its wire transfer instruction or supporting documentation. This way, BCCI was able to cut off the audit trail of many of its illegal transactions.

In sum, combining all these factors, BCCI accomplished its global criminal objectives.

Why Is BCCI Important to Banking Supervisors?

The BCCI case is important to banking authorities worldwide for several reasons. First, the BCCI case is important to those who deeply

believe in consolidated supervision, as it illustrates the importance of understanding the entire banking organization from the top down.

Second, BCCI is important because its methods and activities mocked the very process of supervision and regulation. To be effective, banking authorities must be able to rely on what people tell them. This is particularly important in the United States, where banking organizations must file applications with regulatory authorities to engage in certain banking functions. A bank application is approved not only on the basis of what regulators are able to verify on their own but also on the basis of the applicant's representations. Given the limited resources and the significant number of applications, authorities cannot investigate and verify each representation in each application. Consequently, regulators must be able to rely on such representations as true. For this reason, making false representations to banking authorities is a crime in the United States. The Federal Reserve moves aggressively against anyone who makes deliberate misrepresentations in a bank application, and it has done so with respect to the BCCI nominees. Aggressive enforcement action is designed to deter those who would engage in this type of pernicious behavior, which threatens the integrity of the banking supervisory process.

What Is Being Done to Prevent a Recurrence?

Authorities, both international and domestic, have made significant efforts to prevent the recurrence of another BCCI-like case and to compensate the victims.

International Initiatives

In the aftermath of BCCI, banking supervisory authorities have made an effort to improve international cooperation among themselves. The primary vehicle for such cooperation is the Basle Committee on Banking Supervision, comprising the Federal Reserve, the central bank governors of the other Group of Ten major industrial nations (including Switzerland), and the Governor of Luxembourg's central bank. In focusing on the lessons to be learned from BCCI, the Basle Committee on Banking Supervision has examined such issues as the standardizing of criteria for the establishment by foreign banks of bank branches or subsidiaries; improvement in cross-border information sharing; the relationship between home and host country supervisors relating to the supervision of bank branches; and the question of whether consolidated supervisory responsibility should rest in a single home country supervisor or be shared among several supervisors acting as a college.

The international will to improve cooperation among supervisory authorities received impetus from the BCCI case and has produced tangible results. Nonetheless, several other constructive steps can still be taken. The international community has not yet been able to resolve the problem of ensuring consolidated supervision to guard against the occurrence of another BCCI-type problem. Continued cooperation, therefore, should be a high international priority.

Domestic Legislation in the United States

In the wake of the BCCI failure, the Federal Reserve proposed legislation to enhance the supervision of foreign banks. That proposal was written into the Foreign Bank Supervision Enhancement Act of 1991,[4] which

- bars entry of any foreign bank into the United States unless it is subject to consolidated home supervision and agrees to grant the United States supervisory access to necessary information;
- applies to foreign banks the same financial, managerial, and operational standards governing U.S. banks;
- grants the Federal Reserve the authority to examine any office of a foreign bank in the United States; and
- gives federal regulators the authority to terminate the U.S. presence of a foreign bank that is engaging in illegal, unsafe, or unsound practices.

The legislation establishes uniform federal standards for entry, operation, and expansion of foreign banks in the United States. Also, as a direct result of the new legislation, the size of the Federal Reserve's examination staff has increased.

Criminal Prosecution and Civil Enforcement of Banking Laws in the United States

Criminal and civil actions against BCCI and related individuals and entities have been an important part of the response to the BCCI matter in the United States. Authorities moved swiftly and aggressively against those identified as wrongdoers, focusing on alleged BCCI nominees. The civil and criminal charges brought against Kamal Adham and Ghaith Pharaon, as detailed below, illustrate this approach.

The Federal Reserve, for its part, brought several civil enforcement actions relating to BCCI. The Federal Reserve's enforcement proceedings focus on BCCI's unlawful acquisition or control of banking institutions in the United States. These cases often have been brought in

tandem with criminal prosecutions against individuals and entities. In bringing these cases, the authorities have been guided by two basic goals: to punish the wrongdoers and compensate the victims.

Federal Reserve's Actions Against the BCCI Organization

The Federal Reserve issued a notice of assessment of a $200 million civil money penalty against BCCI itself for its illegal acquisition of the First American group of banks and the National Bank of Georgia. The Federal Reserve's charges were resolved as part of a comprehensive plea agreement that also resolved parallel criminal prosecutions against BCCI brought by the U.S. Department of Justice and the New York County District Attorney. BCCI pled guilty to the criminal charges, and BCCI's U.S. assets, estimated at $550 million, were forfeited to the United States. Under the plea agreement, half of the forfeited assets are to be transferred to the BCCI liquidators for the benefit of a worldwide victims' fund to compensate innocent depositors and other creditors of BCCI. BCCI also consented to the Federal Reserve's $200 million civil money penalty, with the Federal Reserve agreeing to stay collection of the penalty in light of the asset forfeiture. The plea agreement also incorporated a requirement that BCCI's interest in the First American banks would be fully divested. This requirement has been met.

Federal Reserve's Actions Against Individuals

The Federal Reserve brought enforcement actions against several people associated with BCCI, either as senior management or as nominees who acquired and retained control of U.S. banking organizations for BCCI. The Federal Reserve sought to impose civil money penalties on these people and to bar them from future involvement with U.S. banking organizations. Among those people were the founder of BCCI, Agha Hasan Abedi, and its principal officer, Swaleh Naqvi.

Kamal Adham. The Federal Reserve brought an enforcement proceeding against Kamal Adham, charging him with acquiring and holding shares of First American's holding company as a nominee for BCCI. It assessed against him a civil money penalty of $10 million and sought to bar him permanently from banking in the United States. In addition, the New York County District Attorney's Office was prepared to indict Mr. Adham for a number of violations of New York state law. Mr. Adham settled these cases by paying $105 million and agreeing to cooperate with the ongoing investigation of BCCI-related matters. A portion of these funds has already been transferred to the BCCI liquidators for ultimate

distribution to the victims. Mr. Adham has been barred from the banking industry.

Ghaith Pharaon. During a recent administrative hearing, the Federal Reserve's enforcement counsel sought a civil money penalty from Ghaith Pharaon for his role as a BCCI nominee in BCCI's acquisition of the Independence Bank of Encino, California. The Federal Reserve also sought to bar Mr. Pharaon from the U.S. banking industry. To ensure collection of any civil money penalty assessed by the Federal Reserve, the Federal Reserve has obtained a federal district court order restraining Mr. Pharaon's assets in the United States until the completion of the administrative proceedings before the Federal Reserve. In late 1995, Administrative Law Judge Alprin presided over an administrative hearing relating to the Federal Reserve's charges against Mr. Pharaon. On April 12, 1996, Judge Alprin issued a recommended decision that the Board of Governors bar Mr. Pharaon from banking in the United States and assess a fine of $37 million against Mr. Pharaon. If adopted by the Board of Governors, this fine would be the largest ever levied by the Federal Reserve against an individual. Mr. Pharaon also faces three federal indictments and an indictment in New York County.

Khalid bin Mahfouz and the National Commercial Bank of Saudi Arabia. The Federal Reserve brought an enforcement proceeding against Sheik Khalid bin Mahfouz and the National Commercial Bank of Saudi Arabia. They were charged with unlawfully controlling 28 percent of the shares of First American's holding company, Credit and Commerce American Holdings N.V. (CCAH), from 1986 through at least 1990 without the required Federal Reserve approval. The Federal Reserve's enforcement counsel assessed Mr. Mahfouz with a civil money penalty of $170 million. A companion action was brought in the United States District Court for the Southern District of New York to restrain Mr. Mahfouz's assets in the United States, and an injunction was issued by Judge Kimba Wood of that court. Mr. Mahfouz was also indicted in New York County. In December 1993, Mr. Mahfouz resolved these proceedings in a settlement with the Federal Reserve and the New York County District Attorney's Office, agreeing, among other things, to pay a fine of $225 million. Of this sum, $35 million was paid to the U.S. Department of the Treasury, and $1 million was paid to the New York County District Attorney's Office and to the city of New York, largely as a result of the investigation conducted by the District Attorney's Office. The remaining funds, approximately $188 million, are earmarked for the BCCI liquidators for ultimate distribution to the innocent depositors and other creditors of BCCI.

"Abu Dhabi Parties." In January 1994, the so-called Abu Dhabi parties reached a settlement with the U.S. Department of Justice, the New York County District Attorney's Office, the Federal Reserve, the First American Corporation, First American Bankshares, and a court-appointed trustee for the First American Corporation.

Under this agreement, the Abu Dhabi parties agreed, among other things, to transfer all of their equity interest in First American's holding company, CCAH (estimated to be worth approximately $400 million), to produce certain BCCI records, and to surrender custody of Swaleh Naqvi to U.S. authorities for prosecution for conduct relating to BCCI.

Clark Clifford and Robert Altman. The Federal Reserve brought an enforcement action against Clark Clifford and Robert Altman, who served as counsel for BCCI and CCAH and as senior management of the First American organization. The Federal Reserve charged them with multiple violations of law and regulations in connection with their participation in BCCI's secret control of First American. This case is still pending. A New York County jury acquitted Robert Altman of the charges brought against him by the New York County District Attorney's Office.

Use of New Statutory Powers

In vigorously pursuing wrongdoers, both civilly and criminally, the Federal Reserve has used a new provision in U.S. banking law. This provision allows the Federal Reserve to seek an order by a U.S. District Court that restrains assets, in order to facilitate the collection of civil money penalties that are assessed against an individual or entity.

The Pharaon and Mahfouz cases illustrate the operation of this new provision. In ancillary proceedings in the District Court for the Southern District of New York, the Federal Reserve has restrained, among other things, approximately $120 million in cash, a mansion and plantation in the state of Georgia, some artwork, antiques, and stock.

Parallel Proceedings

In many BCCI-related cases in the United States, criminal and civil actions are proceeding on parallel tracks. These actions signal that the authorities will use all of the statutory powers available to them to move aggressively against those who would abuse the banking system.

Fund for Compensating BCCI's Victims

In addition to deterring future banking law violators, the U.S. authorities have, as indicated above, attempted to generate funds to compensate

the victims. Through criminal and civil enforcement proceedings, the U.S. authorities have been able to recover an estimated $1.4 billion from BCCI and related parties thus far. The bulk of this money is intended for the innocent depositors and for other creditors who were defrauded by BCCI.

Lessons to Be Learned

BCCI teaches several lessons. With respect to the big picture, perhaps the most important lesson is that banking supervisors can no longer limit their supervision and regulation of banking organizations to within their geographic boundaries. These national boundaries have little economic significance in modern banking, and traditional notions of territoriality may be exploited by criminal enterprises, such as BCCI.

Furthermore, BCCI teaches that international cooperation is necessary for successful supervision and regulation of multinational banking organizations. Financial fraud in one country can have disastrous consequences in another. To avoid this, supervisors must share information with each other.

The BCCI case also teaches the importance of a heightened awareness of the cultural and legal context from which a foreign bank originates. For example, it is important for supervisors of a foreign bank to be more informed about practices that are prevalent in the bank's home country. This information would enable regulators to understand better the structure of financial transactions conducted by that bank and to detect illegal practices in its operations.

Financing techniques, business customs, and legal principles that exist in the home country of a foreign bank may be profoundly different from those of the host country. A practice that is legal in the home country might well be unlawful in the host country. Naturally, it would be a mistake for a foreign bank to export such a practice from the home country to the host country; if regulators of foreign banks are sensitized to the existence of these practices, it is more likely that they will detect them on a timely basis.

The BCCI case had several illustrations of this point. The use of nominees is one such illustration. In several countries, nominees are legally used to conceal the extent of the true owner's wealth, and it is not uncommon for people to lend their names to others for a fee. However, nominee ownership is unlawful in the United States. A further illustration is the use in certain countries of an "agent" who provides governmental access in return for a "commission." In other countries, this "commis-

sion" may be characterized as a bribe. However, a word of caution is necessary in this respect. While effective supervision may be fostered by considering foreign practices and legal norms, a regulatory authority's sensitivity to such foreign practices should never rise to the level of xenophobia.

The BCCI case teaches supervisors and regulators to be more cynical and to pay closer attention to what is said rather than to who is saying it. It also teaches us that the true ownership of banks may be invisible to authorities because of the practice of using nominees. Supervisors and regulators are now more likely to investigate below the surface for such a possibility and to be less likely to rely on representations as to ownership.

BCCI has also shown that it is important to insist on evidence justifying the rationality of the corporate structure of a banking organization. If regulatory authorities had been more willing to question the rationality of BCCI's corporate organizational structure, the bank may not have grown as large as it did.

Moreover, BCCI shows the potency of foreign secrecy laws and the detrimental effect that those laws can have on the legitimate objectives of bank supervisors and regulators. Crucial information is routinely denied to investigators and valuable time lost because of disputes between national authorities over secrecy laws.

The investigation of BCCI illustrates the types of information subject to secrecy laws that are crucial to a successful investigation. Account information is a good example: BCCI's key booking locations were Luxembourg, the Cayman Islands, and Switzerland. In each of these countries, stringent secrecy laws prohibit the sharing of account information outside its borders. It was no accident that BCCI nested its most confidential transactions in these locations. Secrecy laws impeded the gathering of crucial account information by regulatory authorities from around the world from the books and records of BCCI in secrecy jurisdictions. Such information is vital to understanding financial transactions and tracing funds that may have been misappropriated or embezzled.

In stark contrast to secrecy jurisdictions are the jurisdictions where supervisors cannot promise that they will be able to keep shared information confidential. The United States is such a jurisdiction. Not surprisingly, other national authorities are often less willing or legally unable to share information with the United States. Jurisdictions such as the United States should thoughtfully consider striking a balance between allowing free access to information on a domestic level and cooperating with other countries on supervisory matters.

BCCI highlights the important role that is played by "nonbanking" professionals in the banking industry. BCCI could not have done what it did without the cooperation of the many lawyers, accountants, and trust companies whose services it paid for handsomely. To date, because of the limited resources of the authorities, many of these "allies" of BCCI have been able to escape punishment for their role in what happened.

The BCCI case teaches that external auditors are not an adequate substitute for a supervisory authority's own body of examiners. The auditors' institutionalized conflicts of interest create problems that can be solved only by the use of bank examiners, whose duty is only to the supervisory authority.

To conclude, BCCI teaches an important lesson that might be termed "for whom the bell tolls." In the BCCI case, each regulatory authority looked to the other as having primary responsibility for the multinational bank. Each one expected the other to take that first step. As a result, no one did. The enforcement response of the U.S. authorities in BCCI's aftermath provides an interesting contrast. In that situation, the authorities did not ask for whom the bell tolled; they simply assumed that it tolled for them and acted accordingly.

Because the BCCI fraud shows that national boundaries are no longer significant in banking, supervisors must respond to problems that might in earlier times have been dismissed as "foreign." Perhaps the greatest mistake that any banking supervisor can make is to be passive in the face of a financial problem or fraud on the assumption that someone else will deal with it. At the end of the day, everyone is harmed in some measure by the failure of banks like BCCI. So, do not ask for whom that bell tolls. It tolls for you.

COMMENT

LARRY GURWIN

The Bank of Credit and Commerce International (BCCI) affair has been described as the biggest banking scandal in history. At its height, BCCI collected more than $20 billion in deposits, and a good case can be made that, in effect, all of that money was collected fraudulently because BCCI deceived its depositors about its financial health. Although it claimed to be a solid and profitable institution, it was, in fact, rotting inside. The accounting was so "creative" that BCCI's court-appointed liquidators believe that the bank may never have made a profit during its 19 years of existence.

In a report issued in December 1991, about six months after BCCI was shut down, the liquidators estimated BCCI's total liabilities at $10.64 billion and its realizable assets at $1.16 billion.[1] In other words, a staggering $9.48 billion had been lost and stolen.

These dry figures do not convey the human costs of the scandal. Thousands of individual depositors, many of them people of modest means in Third World countries, saw their savings wiped out. There were other costs: BCCI officials were accomplices in an array of crimes, including the laundering of criminal money, which, of course, facilitated drug trafficking.

One of the biggest mysteries of the BCCI affair is how this criminal enterprise was able to continue for as long as it did with little hindrance from the various "watchdogs" who were supposed to protect the public—the outside auditors, law enforcement agencies, and, of course, banking supervisors. Why did so many watchdogs fail to bark? What steps can be taken to avert new BCCI scandals in the future?

This comment provides a brief summary of the BCCI story[2] and then touches on some apparent failures by the watchdogs.

BCCI was established by Pakistan bankers in 1972. Although its main units were incorporated in Luxembourg and the Cayman Islands, the operating headquarters were in London. Important founding shareholders were Bank of America and Sheikh Zayed bin Sultan al-Nahyan, who was the ruler of Abu Dhabi and President of the United Arab Emirates. The remaining shareholders included prominent persons from Bahrain, Kuwait, Oman, Qatar, and the United Arab Emirates.

During its 19 years of existence, BCCI committed an array of crimes. First, BCCI officials deceived depositors and others about the ownership of the bank. Many of the wealthy and prominent individuals who supposedly owned stock in the bank were merely "straw men" recruited to provide reassurance to potential depositors. Second, BCCI officials drained hundreds of millions of dollars from the bank's coffers through a variety of fraudulent schemes, including loans and commodity futures transactions. Third, they laundered and concealed millions of dollars in criminal money, including cocaine money belonging to leaders of the Medellín cartel and loot from corrupt public officials elsewhere. Fourth, they secretly and illegally acquired control of other financial institutions, including the First American group of banks. Finally, BCCI officials corrupted public officials by providing them with bribes and other inducements, including gifts and "loans" that were not intended to be repaid. This tactic was a crucial part of BCCI's criminal operation, as the protection that BCCI received from powerful friends helps to explain why it was able to operate with impunity for so long.

Throughout BCCI's criminal rampage, the watchdogs who were responsible for protecting the public appeared to be largely oblivious. In this category belong BCCI's independent auditors, various law enforcement agencies, and bank regulators.

An early example of this obliviousness is the reaction to the report prepared on BCCI in early 1978 by Joseph Vaez, a bank examiner for the Office of the Comptroller of the Currency.[3] Based largely on information obtained from Bank of America, which was then one of BCCI's largest shareholders, Vaez's document was extraordinarily prescient, revealing that BCCI was essentially a time bomb. He found that the bank had grown at an extraordinarily rapid rate, that its lending procedures seemed to be highly questionable, and that it made sizable loans to insiders.

There were two other highlights of Vaez's report. First, BCCI seemed to have no policies aimed at preventing an excessive concentration of lending. There was, in Vaez's words, "no internal maximum lending limit."[4] At the time of this report, BCCI's total capital was $63 million, which meant, under one measure, that it would have been imprudent for BCCI to lend more than about $6 million or $9 million to a single borrower. Yet BCCI's loans to one customer—the Gulf Group, controlled by the Gokal family—were a staggering $185 million. This was three times the bank's capital and twenty to thirty times the accepted ratio.

Vaez's second important finding was that, in just over a year, the amount of questionable loans had soared from $27 million to $226 million. The biggest problem was the Gulf Group: $122.5 million of BCCI's $185 million in loans to this group were categorized as substandard.

There were no indications that the Office of the Comptroller of the Currency took any follow-up steps or that it forwarded Vaez's findings to other regulatory agencies in the United States or abroad. This inaction is a significant failure, as the Vaez report showed—13 years before the bank was shut down—that BCCI could well be insolvent.

A second example of the watchdogs' inattention comes from the private hearing hosted in April 1981 by the Federal Reserve, at which bank regulators questioned the Middle Eastern investors who had applied for permission to take over First American. The regulators, for the most part, were extremely gentle and deferential in their questioning. There were discrepancies between the witnesses' testimony at this hearing and other information available to the regulators, yet no one pointed out these discrepancies. Obvious follow-up questions were not asked. The Federal Reserve later approved the application.

A third example is BCCI's indictment in October 1988 by a federal grand jury in Tampa, Florida on money-laundering charges. The case against the bank was settled in January 1990 with a plea bargain. The Tampa drug money case focused worldwide attention on BCCI and opened up new avenues of inquiry. In many cases, bank regulators failed to follow up on these leads. For example, large numbers of BCCI employees were leaving the bank (the outflow accelerated in 1990, when thousands were laid off), and many of them were willing to talk about what they had learned inside the institution. Several former employees, who were interviewed by journalists, had not been approached by law enforcement authorities or banking regulators.

A fourth example is the allegations in 1990 by some former BCCI employees in London that the bank had packed up thousands of pages of documents to be shipped to Abu Dhabi, as the bank would soon be moving its headquarters there. No action was taken by the Bank of England to prevent these records from leaving British soil, and many of them were destroyed.

Why did the bank supervisors fail for so long to detect BCCI's criminality? In some cases, there were legal or institutional constraints, such as limits on the powers of the banking supervisors. In other cases, sheer ineptitude seems to have been involved. There are also indications that, in some countries, BCCI had extremely cozy relationships with banking supervisors.

A former BCCI official, Akbar Bilgrami, gave one example in testimony to a U.S. Senate committee.[5] Bilgrami said that in about 1980 Swaleh Naqvi, a principal officer of BCCI, asked him to take a senior official from an African central bank on a shopping spree at Harrods in

London. BCCI paid the bill, which was about £78,000. In return, the official was asked to deposit several million dollars of his country's foreign exchange reserves in BCCI. Another BCCI official, Abdur Sakhia, has testified about an incident that purportedly took place at a meeting of central bank officials in 1985: "I saw one of the BCCI officers with a lot of cash, handing [it] out to the staff of the central bank of Nigeria. This is what I saw personally being given to them."[6]

Robert Morgenthau, the New York County District Attorney, has alleged that BCCI paid bribes to central bankers or other financial officials in a dozen developing countries. Morgenthau played a leading role in exposing BCCI's crimes and recovering money for the victimized depositors. Morgenthau is an example—not the only one—of a watchdog who did do his job. Other public servants in law enforcement agencies, central banks, and other institutions have performed admirably, including the U.S. Customs agents who risked their lives in the undercover operation that led to the drug money indictment in Tampa.

What can be done to prevent future BCCIs? First, be wary of poorly regulated financial centers. There is a tendency in the banking community to talk about financial havens as if they play an important and legitimate role in international finance. Is the world a better place because of the existence of these inadequately regulated financial havens? Arguably, there is no legitimate reason for these centers to exist, and somebody should pull the plug on them. If that is not possible, entities that are organized in such centers should be prevented from doing business in other countries.

Second, banking institutions must not be allowed to fall through the cracks as BCCI did. A decade before BCCI was shut down, regulators failed to expose the massive frauds at Italy's Banco Ambrosiano, partly because that bank exploited similar gaps in the international regulatory regime. Banco Ambrosiano's chairman, Roberto Calvi, carried out many of his frauds through foreign subsidiary banks that he controlled through a Luxembourg holding company. This effectively shielded him from the prying eyes of the Bank of Italy's inspectors. The Luxembourg banking authorities, for their part, exercised no supervision over Calvi's holding company because it was not licensed as a bank—even though it had the word "banco" in its name. After that debacle, regulators promised that they would take serious steps to prevent such an event from happening again. As the BCCI affair makes clear, they clearly did not do enough.

Third, banking supervisors should do more to exchange and pool information. In the case of BCCI, this sharing of information was not done for years and, even then, only on a partial basis. One example that

stands out is the apparent failure to follow up and circulate Joseph Vaez's findings.

Finally, when licensing new banks or reviewing applications to acquire control of existing banks, banking supervisors must conduct serious and thorough due diligence investigations.

Some regulators have said that it is wrong to expect bank supervisors "to be policemen" or "to act like detectives." Why is that wrong? The public desperately needs protection from corrupt bankers, such as the men who ran BCCI. If banking supervisors are unwilling to act like policemen, who will protect the people?

Chapter 20 | The Role of Deposit Insurance: Financial System Stability and Moral Hazard

JAMES R. BARTH[1] and R. DAN BRUMBAUGH, JR.

The U.S. banking system has attracted substantial attention during the past 15 years. Most of the attention has focused on the large number of failed depository institutions (commercial banks, savings banks, savings and loans, and credit unions) and their unprecedented resolution costs. This attention is certainly appropriate, given the failure from 1980 through 1992 of more than 4,500 federally insured depository institutions with approximately $650 billion in assets and the subsequent resolution by federal authorities at an estimated present-value cost of nearly $165 billion.

Additional attention has been paid to the diminished role of the surviving U.S. depository institutions and the way in which they are adapting to a rapidly changing environment. U.S. depository institutions have been steadily losing market share to other, less-regulated financial service firms. From 1950 through 1993, the share of depository institutions in total U.S. financial assets held by all financial service firms fell by nearly 50 percent (Table 1).

U.S. depository institutions have reacted to their diminishing role by rearranging their balance sheets. All depositories have placed a greater emphasis on real estate loans. Commercial banks, savings banks, and savings and loan institutions have emphasized both home mortgages and commercial real estate, while credit unions have emphasized only home mortgages. Larger commercial banks have increased fee and other noninterest income through off-balance-sheet activities, such as interest rate and foreign exchange swaps. Other less traditional activities, such as managing and selling securities and insurance products and services, have also been increasing. This trend is especially true for those state-chartered institutions that have been granted wider powers than federally chartered institutions, and for several of the largest bank holding companies, which have also been permitted greater leeway to engage in such activities. Depositories have also been cutting costs wherever possible, including by laying off employees.

The large number of costly depository institution failures and the changing role of depository institutions in the U.S. financial marketplace have understandably raised many questions. A number of important

questions are being asked: What caused all the failures and the huge resolution costs? Why are depository institutions losing market share? Are depository institutions becoming obsolete? Should the Federal Government provide financial stability through deposit insurance, given the evolving environment of depositories? Similar questions about the evolution of financial institutions and their regulation are being asked in countries around the world, as their financial institutions, too, are adapting to changing market conditions.

These are some of the issues that this chapter attempts to address. In the next section, the turmoil that occurred in the U.S. banking system over the past 15 years is described. Then, the erosion in market share experienced by U.S. banking institutions over the same period is addressed. The third section explains why the failures were so numerous and costly, and why market shares have evolved as they have. In the fourth section, key aspects of the present U.S. regulatory system and their effect on the evolution of the U.S. banking system are described, and the diminished role of deposit insurance is addressed. Lastly, the implications of the U.S. banking experience for the evolution of financial and regulatory institutions in the United States and other countries are considered.

Numerous Failures and Huge Failure Costs

The 1980s will be remembered as the worst decade for banking institutions since the Great Depression of the late 1920s and early 1930s. The failures in the savings and loan industry were so numerous and costly that the federal insurance fund for the institutions, the Federal Savings and Loan Insurance Corporation (FSLIC), reported insolvency in 1988 in the amount of $75 billion. It was dissolved the following year, with taxpayers paying to clean up the mess. As Table 2 shows, 1,142 savings and loans with $390 billion in assets failed from 1980 through 1992; the cost to resolve these failures has an estimated present value of $127 billion. The FSLIC was replaced in 1989 by a new insurance fund, the Savings Association Insurance Fund (SAIF), for the solvent savings and loans that remained. The SAIF is administered by the Federal Deposit Insurance Corporation (FDIC).

Despite worrisome developments throughout the decade, commercial and savings banks were much more fortunate than savings and loan institutions. As Table 3 shows, although 1,503 of these institutions failed, with $259 billion in assets, they were resolved at an estimated present-value cost of only $37 billion. As a result, although the federal insurance fund for these institutions, the Bank Insurance Fund (BIF), did report

Table 1. Distribution of U.S. Financial Assets Held by All Financial Service Firms

(In percent of total assets, unless otherwise indicated)

	1950	1960	1970	1980	1990	1993
Depository institutions[1]	**64.9**	**58.0**	**58.6**	**54.2**	**40.9**	**33.6**
Commercial banks	51.2	38.2	38.6	34.3	27.7	25.1
U.S.-chartered	50.5	37.5	36.6	29.3	22.0	19.1
Foreign offices in United States	0.4	0.6	0.7	2.3	3.0	3.4
Bank holding companies	—	—	1.1	2.4	2.5	2.5
Banks in U.S. possessions	0.3	0.1	0.3	0.3	0.2	0.2
Savings institutions	13.4	18.7	18.7	18.3	11.4	6.7
Savings and loans	5.8	11.8	12.8	14.4	9.1	...
Savings banks	7.6	6.9	5.9	3.9	2.2	...
Credit unions	0.3	1.1	1.3	1.6	1.8	1.8
Contractual intermediaries	**29.4**	**33.5**	**31.6**	**31.1**	**35.5**	**37.8**
Life insurance companies	21.3	19.4	15.0	10.7	11.4	11.6
Other insurance companies	4.0	4.4	3.7	4.2	4.4	4.1
Private pension funds[2]	2.4	6.4	8.4	11.7	13.6	15.2
State and local government retirement funds	1.7	3.3	4.5	4.5	6.1	6.9
Others	**5.8**	**8.7**	**9.6**	**14.7**	**23.5**	**28.4**
Finance companies	3.2	4.6	4.8	4.7	5.1	4.3
Mortgage companies	...	...	...	0.4	0.1	0.2
Mutual funds[3]	1.1	2.9	3.5	1.4	5.0	9.3
Money market mutual funds	—	—	—	1.8	4.1	3.6
Closed-end funds	...	...	...	0.2	0.4	0.6
Security brokers and dealers	1.4	1.1	1.2	1.0	2.2	3.0
REITs[4]	0.1	0.1	0.1	0.1	0.1	0.1
Issuers of asset-backed securities	—	—	—	—	2.3	3.0
Bank personal trusts[5]	...	...	...	5.1	4.2	4.3
Total assets (in billions of U.S. dollars)	**294**	**597**	**1,340**	**5,910**	**12,017**	**15,387**

Source: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts* (various issues). The flow of funds accounts was restructured in the second quarter of 1993.

[1] Commercial banks consist of U.S.-chartered commercial banks, domestic affiliates, Edge Act corporations, agencies and branches of foreign banks, and banks in U.S. possessions. Foreign banking offices in the United States include Edge Act corporations and offices of foreign banks. International banking facilities are excluded from domestic banking and treated like branches in foreign countries. Savings and loan associations include all savings and loan associations and federal savings banks insured by the Savings Association Insurance Fund. Savings banks include all federal and mutual savings banks insured by the Bank Insurance Fund.

[2] Private pension funds include the Federal Employees' Retirement Thrift Savings Fund.

[3] Mutual funds are open-end investment companies (including unit investment trusts) that report to the Investment Company Institute.

[4] REITs are real estate investment trusts.

[5] Bank personal trusts are assets of individuals managed by bank trust departments and non-deposit, noninsured trust companies.

Table 2. Failed and Insolvent U.S. Savings and Loans

Year	Number of Failures	Failure Assets (In millions of U.S. dollars)	Failure Costs (In millions of U.S. dollars)	Failure Costs as Percent of Failure Assets	Number of Months Insolvent Before Closure	Number of Insolvent Institutions	Insolvent Institution Assets (In billions of U.S. dollars)	Insurance Fund Reserves (In billions of U.S. dollars)
1980	11	1,459	166	11.4	5.4	43	—	6.5
1981	28	13,907	760	5.5	5.2	112	29	6.2
1982	63	17,663	806	4.6	12.9	415	220	6.3
1983	36	4,630	275	5.9	16.4	515	234	6.4
1984	22	5,080	743	14.6	23.4	695	336	5.6
1985	31	6,366	1,026	16.1	25.9	705	335	4.6
1986	46	12,450	3,066	24.6	30.6	672	324	–6.3
1987	47	10,664	3,704	34.7	35.7	672	336	–13.7
1988	205	101,242	31,790	31.4	42.0	508	283	–75.0
1989	37	10,808	5,914	54.8	36.0	517	283	—
1990	315	94,248	37,302	39.6	43.0	563[1]	395[1]	—
1991	232	75,947	34,506	45.4	41.0	437[1]	278[1]	0.1
1992	69	35,338	6,715	19.0	38.0	200[1]	127[1]	0.3
Total	1,142	389,802	126,773	32.5	—	6,054	3,180	—

Sources: Federal Home Loan Bank Board, Office of Thrift Supervision, Resolution Trust Corporation, and authors' calculations.

[1] Private sector institutions classified by the Office of Thrift Supervision as troubled, with poor earnings and low capital or expected transfers to the Resolution Trust Corporation.

Table 3. Failed and Problem U.S. Commercial and Savings Banks

Year	Number of Failures	Failure Assets (In millions of U.S. dollars)	Failure Costs (In millions of U.S. dollars)	Failure Costs as Percent of Failure Assets	Number of Months Rated "4" or "5" Before Closure[1]		Number of Problem Banks	Problem Bank Assets (In billions of U.S. dollars)	Insurance Fund Reserves (In billions of U.S. dollars)
					Mean	Maximum			
1980	10	236	30	12.7	15	30	212	. . .	10.0
1981	10	4,859	589	12.1	19	34	223	. . .	12.2
1982	42	11,632	1,271	10.9	16	35	369	. . .	13.8
1983	48	7,207	1,521	21.1	19	45	642	. . .	15.4
1984	79	3,276	2,292	70.0	15	39	848	228	16.5
1985	120	8,337	850	10.2	15	58	1,140	238	18.0
1986	145	6,830	1,732	25.4	20	65	1,484	336	18.3
1987	203	9,198	2,017	21.9	21	67	1,575	359	18.3
1988	221	52,623	5,530	10.5	24	74	1,406	252	14.1
1989	207	29,538	5,998	20.3	28	88	1,109	236	13.2
1990	169	15,365	3,402	22.1	34	109	1,046	409	4.0
1991	127	63,338	7,393	11.7	29	89	1,090	610	-7.0
1992	122	46,158	4,700	10.2	32[2]	126[2]	863	464	-0.1
Total	1,503	258,597	37,325	14.4	—	—	12,007	3,132[3]	—

Source: Federal Deposit Insurance Corporation.

[1] A rating of "4" or "5" is assigned by the regulatory authorities to problem banks.

[2] Including failures only through October 1992.

[3] Total for 1984–92 period.

insolvency in both 1991 and 1992, it returned to solvency in 1993. The BIF is also administered by the FDIC.

While credit unions also experienced difficulties in the 1980s, their condition did not deteriorate sufficiently to pose a serious risk to taxpayers. As Table 4 shows, 2,050 credit unions failed, with $2.8 billion in assets, but they were resolved at an estimated present-value cost of only $452 million. Moreover, the federal insurance fund for these institutions, the National Credit Union Share Insurance Fund (NCUSIF), never reported insolvency. As a result of losses in the early 1980s and the recognition that the premiums being collected were not adequately funding the NCUSIF, the credit unions themselves recapitalized their insurance fund in 1985 with a 1 percent levy on the insured shares or deposits of each federally insured credit union. Since then, the NCUSIF has resolved hundreds of failed institutions while simultaneously increasing its reserves.

Steady Loss of Banking Institutions' Market Share

In addition to the large number of failed depository institutions and their costly resolution, depository institutions have suffered from still another problem. In 1950, as Table 1 shows, depository institutions accounted for 65 percent of the total assets of all financial service firms in the United States. By 1993, however, this percentage had declined by nearly half, to 34 percent. The biggest losers in terms of market share have been the U.S.-chartered commercial banks, whose share declined to 19 percent in 1993 from 51 percent in 1950. The share for savings banks fell to 2.2 percent in 1990 from 7.6 percent in 1950. Savings and loans increased their share from 5.8 percent in 1950 to 14.4 percent in 1980, only to decline to 9.1 percent in 1990. Reflecting the savings and loans' decline, the Federal Reserve no longer reports separate data for savings banks and savings and loan institutions; instead, it combines them into "savings institutions" for reporting purposes. Credit unions, meanwhile, have seen their share increase sixfold, from 0.3 percent to 1.8 percent during the post-World War II period.

Among nondepositories, the big gainers in market share have been private pension funds and state and local government retirement funds. The collective share of these funds increased to 22 percent in 1993 from 4 percent in 1950. They now account for a larger share of the total assets held by all financial service firms than U.S.-chartered banks. The other big gainers have been money market and other mutual funds, whose collective share increased 1,200 percent from 1950 to year-end 1993, from 1 percent to 13 percent. These funds are now more important in terms

Table 4. Failed and Problem U.S. Credit Unions

Year[1]	Number of Failures	Failure Assets (In millions of U.S. dollars)	Failure Costs (In millions of U.S.dollars)	Failure Costs as Percent of Failure Shares	Number of Months Rated "4" or "5" Before Closure[2]	Number of Problem Credit Unions	Problem Credit Union Assets (In billions of U.S. dollars)	Insurance Fund Reserves (In billions of U.S. dollars)
1980	...	...	...	...	...	1,018	2.4	0.2
1981	349	...	...	...	...	1,174	3.0	0.2
1982	327	...	...	...	...	1,192	4.6	0.2
1983	253	...	...	...	69.6	1,124	4.7	0.2
1984	130	208	19.9	9.6	80.8	872	4.1	0.3
1985	94	47	11.6	24.7	64.9	742	4.1	1.1
1986	94	116	28.6	24.7	55.4	794	6.6	1.4
1987	88	327	51.7	15.8	44.1	929	8.1	1.6
1988	85	297	33.3	11.2	30.1	1,022	10.6	1.9
1989	114	285	74.0	26.0	24.0	794	8.4	2.0
1990	189	485	48.7	10.0	17.5	678	9.4	2.1
1991	173	298	76.8	25.8	...	685	10.4	2.3
1992	154	773	107.4	13.9	...	608	7.4	2.6
Total	2,050[3]	2,836[4]	452.0[4]	15.9[4]	—	11,632	83.8	—

Source: National Credit Union Administration.

[1] Fiscal year basis.

[2] A rating of "4" or "5" is assigned by the regulatory authorities to problem credit unions.

[3] Total for 1981–92 period.

[4] Total for 1984–92 period.

Table 5. Selected Balance Sheet Items of U.S. Households, Personal Trusts, and Nonprofit Organizations

(In percent of total financial assets, unless otherwise indicated)

	1950	1960	1970	1980	1985	1990	1993
Checkable deposits and currency	. . .	. . .	. . .	4	4	4	5
Small time and savings deposits	. . .	. . .	. . .	18	19	16	11
Money market fund shares	. . .	. . .	. . .	1	2	3	3
U.S. government securities	15	8	5	4	4	6	3
Corporate and foreign bonds	1	1	2	1	1	1	0
Mortgages	4	3	2	2	1	2	1
Mutual fund shares	. . .	. . .	. . .	1	2	4	6
Corporate equities	30	41	38	17	16	13	17
Life insurance reserves	12	9	7	3	3	3	3
Pension fund reserves	5	9	12	14	20	24	28
Total liabilities	8	23	25	23	24	28	25
Total financial assets (in billions of U.S. dollars)	447	973	1,917	6,391	9,819	13,984	17,230

Source: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts* (various issues).

of market share than savings banks and savings and loan institutions combined, and they are rapidly approaching the importance of U.S.-chartered commercial banks.

As the provision of financial services has evolved, individuals and households (including personal trusts and nonprofit organizations) have dramatically changed the composition of their financial assets. As Table 5 shows, 57 percent of all household financial assets in 1950 were in corporate equities, U.S. government securities, and life insurance reserves. Today, households hold only 23 percent of their assets in those categories, a drop of 34 percentage points. At the same time, net household holdings in pension fund reserves, money market funds, and other mutual funds have increased by 32 percent. Households have shifted from direct holdings of stocks and bonds and holdings in depositories and life insurance companies to indirect holdings of stocks and bonds through pension funds, money market funds, and other mutual funds.

This pattern of shifting shares reflects, in part, an increase in competition that, in turn, largely resulted from developments in computer and telecommunications technology. Technology has been increasingly reducing the traditional need for depositories to intermediate between borrowers and lenders through its gathering, evaluation, and monitoring of information on borrowers, which was too costly an activity for lenders themselves to perform. Securitization has turned formerly illiquid assets on bank balance sheets, such as mortgages, automobile loans, credit card receivables, and, increasingly, commercial real-estate loans, into securities that can be held by individuals and by many firms (including pension funds, mutual funds, and insurance companies). For example, according to data from the Federal Reserve, although the depository institutions' share of all home mortgages dropped from 60 percent in 1950 to 35 percent today, 41 percent of these mortgages have been securitized. Mutual funds have allowed consumers to hold indirectly a diversified portfolio of financial assets in relatively small denominations. Overall, this technological revolution and the developments in finance theory have manifested themselves in new products, new firms, lower costs of providing financial products, and lower prices for products.

The line of causation creating the profound change in the pattern of providing financial services is relatively clear. First came the technological advances that lowered the cost of gathering, processing, transmitting, and monitoring information. Then came the changes in providing financial products as a result of the technological change, such as securitization and the development of money market and other mutual funds. Finally, households have over time shifted their holdings of financial assets, fueling the growth in nonbank financial service firms.

Causes of Costly Failures and Lost Market Share

The costly depository institution failures and the decline in the depositories' share of the total assets of all U.S. financial service firms not only reflect the market forces just described, but also other economic shocks and regulatory forces. In the late 1970s and early 1980s, inflation and interest rates became highly volatile. For a time in the early 1980s, short-term interest rates rose above long-term interest rates, particularly harming savings and loan institutions that were required by regulation to fund their long-term, fixed-rate mortgage loans with shorter-term deposits at more variable rates. In 1981, tax law changes stimulated real-estate investments. In 1986, however, the effect of the tax law changes was more than reversed, significantly harming real estate markets and depositories that had previously increased their real estate lending and investments. Fluctuations in energy prices, including the largely unexpected decline in oil prices from $28 a barrel to $10 in the first quarter of 1986, contributed to regional economic disruptions that harmed depositories that had lent or invested in those areas.

Throughout the 1980s, laws and regulations limited the ability of depositories to adapt to changing market conditions, including their ability to offer adjustable-rate mortgages, to diversify geographically, to offer market rates of interest on their deposits, and to engage in a range of securities and insurance activities. Although some of these restrictions were eliminated or relaxed over the decade, these changes were generally made in reaction to market forces that had already damaged depositories. Furthermore, restrictions still remained that impeded the ability of depositories to adapt to continued competition.

This pattern is a by-product of the access of depository institutions to federally insured deposits, which creates incentives that need to be addressed with "safety and soundness" regulations. With deposit insurance, only stockholders and unsecured creditors—not insured depositors—face the risk of loss of funds. Once stockholders have lost their equity capital, moreover, the federal insurer effectively bears any further losses. This situation gives rise to a moral hazard problem, in which a depository institution, once insured, has an incentive to engage in riskier activities. It is thus the responsibility of the insurer to contain this proclivity through safety and soundness regulations, including minimum required capital levels, risk-based capital requirements, risk-based deposit insurance premiums, restrictions on the pricing of products and services, geographical limitations on operations, constraints on involvement in various activities, and ownership restrictions.

While these regulations are designed in the last analysis to protect the insurer against losses, they can impede the ability of the depositories to compete with less-regulated financial service firms. These regulations can prevent depository institutions from altering their mix of products and services to serve their customers in a timely manner—if at all—and they raise the costs of doing business. As a result, in a changing market environment, customers of depositories can be lost to financial service firms that are able to service the demands of customers more efficiently. The outcome is predictable: more competition means increased failures of depository institutions and, more generally, excess capacity in the depository institutions.

This pattern gives rise to the problem of potentially costly exits from such industries. Tables 2–4 present information on the exit costs for federally insured depository institutions from 1980 through 1992. Failed commercial and savings banks cost on average about 14 percent of their assets to resolve (Table 3). These costs, however, ranged from a low of 10 percent of assets in 1985 and 1992 to a high of 70 percent in 1984. The failure resolution costs for savings and loan institutions were significantly higher as a percentage of assets. Their average cost was 33 percent, with a low of 5 percent in 1982 and a high of 55 percent in 1989 (Table 2). In the case of credit unions, the average failure resolution cost as a percentage of assets was about 16 percent, with a low of 10 percent in 1984 and a high of 26 percent in 1991 (Table 4).

In part because of forbearance on the part of the regulatory authorities, the costs of exit for many of the institutions that failed have been excessive. As can be seen in Tables 2–4, federally insured depository institutions for relatively lengthy periods of time were either rated by the authorities as problem institutions or reported insolvency before being resolved. For both commercial and savings banks, the average length of time between being identified as a problem institution and resolution tended to increase from 1980 through 1992. Table 3 shows that this regulatory delay lengthened while the number of problem institutions and their assets generally were also increasing. This table also shows that throughout the entire period the insurance fund reserves were steadily decreasing.

The excessive resolution costs for savings and loans are even more egregious because these institutions were reporting insolvency for lengthy periods before they were resolved. As Table 2 shows, the average delay in resolving savings and loans increased from 5 months in the early 1980s to about 40 months—more than 3 years—in the late 1980s and early 1990s. While the delay in resolution lengthened steadily, both the number and the assets of insolvent institutions reached substantial levels in the

middle and later half of the 1980s. Not coincidentally, the federal insurance fund itself reported insolvency for the first time in its existence in 1986. Two years later, its insolvency amounted to $75 billion.

The regulatory authorities' record for taking action against problem credit unions is much better than for the other depository institutions. Table 4 shows that, nonetheless, the closing of problem credit unions was clearly delayed. The length of delay, however, steadily declined once the insurance fund was recapitalized in 1985.

A major lesson to be learned from these data is that having little or no equity capital at risk provides depository institutions with a significant incentive to engage in excessively risky activities. Even projects whose expected present value may be negative are undertaken, because upside gains from such projects accrue to the benefit of the depository institution and its owners, whereas the downside losses are borne by the insurer. Regulatory forbearance gives institutions time to engage in such behavior. Even without undertaking excessively risky projects, moreover, institutions with little or no equity capital at risk may pay out excessive salaries, dividends, and directors' fees.

The struggle to compete in a situation of excess capacity and lax regulation and supervision can produce excessive exit costs for depository institutions. Failures per se were not the most egregious problem over the past 15 years: the problem was the excessive costs required to resolve these failures, costs that were so enormous in the case of savings and loans that taxpayers have been required to assist in cleaning up the mess.

Diminished Role of Deposit Insurance

The goal of regulation is to provide a stable, efficient, and competitive financial system. The major problem that arises with banking institutions is that they offer deposits that are payable on demand at par or face value and that are used to fund longer-term assets that are illiquid and risky. The result is that depositors may become nervous about the safety of their funds and stage a run on those depositories that they perceive to be unsound, because withdrawals are honored on a first-come, first-served basis. Widespread or systemic runs can cause disruptions to the payments system and to the credit system, as otherwise healthy institutions are forced into insolvency by selling assets at "fire-sale" prices.

In the United States, the solution to this potential calamity for both the financial and real sectors of an economy has been the establishment of a lender of last resort (the Federal Reserve) and federal deposit insurance. The benefit of these two devices is stability. In particular, a source

of liquidity is available at all times, and adequate funds are available to cover all failure resolution costs, which assures the maintenance of depositors' confidence and the elimination of systemic runs. The costs are less efficiency and less competition than would otherwise exist because of the safety and soundness regulations that are imposed, including the accounting system, the restrictions on powers and activities, and the closure and resolution procedures.

The point may have been reached at which the costs are now exceeding the benefits, particularly in view of the declining importance of insured deposits in funding assets held by financial service firms. The value of insured deposits has been eroding over the years. As Table 6 shows, insured deposits fund only 55 percent of the assets of federally insured depository institutions and only 17 percent of the total assets of all financial service firms. At the same time, transaction accounts represent only 17 percent of assets, and commercial and industrial loans account for only 12 percent of the assets of BIF- and SAIF-insured depository institutions.

These figures raise the following questions: Is the importance of insured deposits in providing financial stability overstated? After all, how vulnerable can the payments and credit mechanisms be if, as Table 6 shows, only 17 percent of assets at depositories are funded by transaction accounts, which, in turn, represent only 5 percent of assets of all financial service firms? If business loans represent only 12 percent of depository assets, are these loans the core business of banking? Given that 45 percent of depository assets are funded by uninsured liabilities, are insured deposits really a "low-cost" source of funds that will enable banks to compete successfully against nonbank financial service firms? Is the burden of safety and soundness regulations on depositories really necessary, given that insured deposits represent only 17 percent of all assets of financial service firms?

Responding to Contemporary Challenges: Reform of Deposit Insurance and Safety and Soundness Regulations

These questions and their answers hold many implications for the reform in the United States of deposit insurance and safety and soundness regulations. For instance, an agenda for regulatory reform must pass a two-part test. It must meet the fundamental goal of bank regulation by protecting the payments and credit mechanisms from disruption while promoting competition. Meeting both parts of this test is the only way to maximize the efficient allocation of scarce economic resources.

Table 6. Federally Insured Depository Institutions, 1993

Number of institutions	13,221
Total assets (in billions of U.S. dollars)	4,707
Total deposits (in billions of U.S. dollars)	3,528
Insured deposits (in billions of U.S. dollars)	2,582
Transaction accounts (excluding U.S. Government and depository institutions; in billions of U.S. dollars)	821
Commercial and industrial loans (in billions of U.S. dollars)	549
Total deposits (as share of total assets, in percent)	75.0
Insured deposits (as share of total assets, in percent)	54.9
Transaction accounts (as share of total assets, in percent)	17.4
Commercial and industrial loans (as share of total assets, in percent)	11.7
Total assets of all financial service firms (in billions of U.S. dollars)	15,387
Insured deposits (as share of financial service firm assets, in percent)	16.8

Sources: Federal Deposit Insurance Corporation and Federal Reserve.

In the contemporary environment, there are four basic approaches to regulatory reform. The first approach would be to protect depositories from competition by granting monopoly-like powers where possible to banks and by attempting to impose regulatory restrictions on nondepository financial service firms. This reform would be an extension of the current regulatory policy of attempting to erect barriers to entry and exit in the provision of financial products and services. In an environment of rapid competitive change, this approach is increasingly counterproductive.

A second approach to reform would be to maintain the deposit insurance system while installing a mechanism to correct promptly and, if necessary, close troubled institutions. A form of this second approach was adopted in 1991 in the Federal Deposit Insurance Corporation Improvement Act.[2] This Act provided for corrective action—basically, intervention by regulators that ultimately involved seizure and resolution based on declining levels of book value net worth or capital. In addition to using book value accounting rather than market value accounting, this Act allowed for significant regulatory discretion. In the recent past, using these techniques has led to a slow and costly resolution of troubled depositories. Even if these difficulties could be overcome, this approach may be seen to impede or at least not further the ability of healthy banks to adapt to competitive developments in financial markets, because the Federal Deposit Insurance Corporation Improvement Act imposes or

fails to eliminate significant limitations on the activities of banking institutions.

A third approach to reform would eliminate deposit insurance and adopt a form of what is called the narrow bank. Under this proposal, deposit insurance would be eliminated without eliminating the protection that deposit insurance was designed to provide for small and unsophisticated depositors, the payments and credit mechanisms, and the taxpayer.

To understand this third approach, it is necessary to consider some theory. To prevent runs and to provide individuals with a perfectly liquid asset—one that is payable on demand at par with extremely low user cost—the third proposal would create a narrow bank at every depository. The assets of the narrow bank would be short-term treasury securities. In certain circumstances, other liquid and marketable assets could be included. The liabilities would be demand deposits or transaction accounts only. As a result, the return to the depositor would essentially be limited to the return on short-term treasury securities minus fees for servicing accounts.

Simultaneously, the third proposal would eliminate all other regulatory constraints on depositories except those that apply to other financial service firms, such as Securities and Exchange Commission disclosure requirements, consumer protection requirements, and all requirements implicit in avoiding antitrust violations. Thus, this proposal is designed to promote efficiency because the new, "non-narrow" bank, associated with but separated functionally from the narrow bank, would become a purely private financial service firm with the ability—in common with all other financial service firms—to adapt to competition.

The fourth approach involves eliminating deposit insurance and creating a federal money market mutual fund. As with the previous proposal, this approach would eliminate deposit insurance. It would also eliminate all regulatory constraints on depositories except those that apply to other financial service firms. The difference is that, instead of creating just a narrow bank at former depositories, this approach would also create a federal government money market mutual fund. There is, of course, no reason why banks should not be able to offer competing money market mutual funds or risk-free accounts in narrow banks if they so chose.

As with the narrow bank, assets of the government money market mutual fund would be short-term treasury securities, and liabilities would be demand deposits only. Access to the fund would be through check writing or debit cards issued to those wishing to purchase shares in the fund. The fund would allow all government checks, such as payroll, social

security, and welfare checks, to be deposited electronically—a service that could also be provided through the narrow bank.

Under the fourth approach, all non-narrow banks would become purely private financial service firms with the ability to adapt to competition as do other financial service firms. The goals of deposit insurance would also be met. The provision of the money market mutual fund through the Government is also a function for which the Government—more so than the narrow bank—seems particularly efficient. Basically, a large-scale electronic debit and credit mechanism, requiring a sophisticated computer network and retail outlets at, for example, post offices would be required. There is, incidentally, a historical precedent for this type of mechanism: postal banks.

This approach has other advantages over the narrow bank approach alone. The proposal would create a vehicle to provide low-income individuals with certain financial services at low cost; it may represent a more efficient alternative to providing such services to low-income individuals through banks, community development banks, or narrow banks. At the moment, individuals with low incomes have difficulty cashing checks and establishing checking accounts of their own, in part because of a shortage of financial service outlets near their homes. In addition, theft of government checks is a problem. With access to the government money market mutual fund, these individuals could have checks deposited in their accounts and draw down on these accounts through the use of checks or debit cards. Electronic transfer of funds to pay bills could also be arranged easily. The government money market fund would become an efficient, low-cost provider of universal liquidity in the United States. In essence, just as the Government has provided currency over the years, it would be updating the process by providing the modern-day equivalent of such a payments vehicle.

Finally, it is frequently said that implicit federal deposit insurance exists even for the narrow bank because if difficulties arose—however remote the possibility—the Government would step in to protect depositors. This reform proposal eliminates this prospect because the Government provides a liquidity service in the first place. Individuals would never need to run to currency issued by the Government.

Conclusions

One approach to setting a regulatory agenda for banks that is applicable to almost all countries is first to examine whether the existing regulatory structure is consistent with the goals of bank regulation. The main role of bank regulation is to maintain confidence and, hence, stability in

the financial system because a stable financial system facilitates the efficient allocation of scarce economic resources, which is the primary function of the financial system. The fundamental goal of bank regulation is thus to promote the efficient allocation of scarce economic resources by minimizing disruptions in the payments and credit mechanisms.

Another goal of bank regulation is to promote competitive financial markets. Regulation itself can inhibit competition and the efficient allocation of scarce economic resources. Various ways in which restrictions on the activities of banking institutions can limit competition and create excess capacity have been pointed out in this chapter. These outcomes, in turn, impede the efficient allocation of scarce economic resources.

Many of the current restrictions were adopted in the United States in legislation in the 1930s. They have evolved since then with changes in legislation and regulation that were essentially ad hoc adaptations to specific problems that appeared to need immediate attention. This pattern holds particularly true for the federal legislation since 1980. These changes, however, fundamentally ignored the development that could not have been envisioned in the 1930s but exploded dramatically in the 1980s: the revolution in computer and telecommunications technology, which, in turn, has spurred dramatic competition in the provision and distribution of financial products and services.

Market-driven forces have created and distributed new financial products and services. Federally insured and regulated depositories are finding it difficult to adapt to the competition because of the regulations under which they operate. As a result, depositories are suffering from a long-term decline in profitability, an increase in risk, and costly exits. Current attempts by banks to secure profitability by shifting on-balance-sheet assets, moving to off-balance-sheet assets, and seeking fee-based income are unlikely to overcome the long-term competitive disadvantages imposed by regulatory limitations and restrictions.

A regulatory reform proposal must pass a two-part test. It must meet the fundamental goal of bank regulation by protecting the payments and credit mechanisms from disruption while promoting competition. Meeting both parts of this test is the only way to maximize the efficient allocation of scarce economic resources.

Two reform proposals that would eliminate deposit insurance have been described. These proposals would nonetheless provide the same protection that deposit insurance was designed to provide: protection for small and unsophisticated depositors, protection of the payments and credit mechanisms, and protection of the taxpayer. One proposal would simply adopt a form of the narrow bank, while the other would create

both a narrow bank and a federal government money market mutual fund.

The financial institutions in all developed countries of the world are subject to most of the competitive pressures that have contributed to the turmoil among depository institutions in the United States in the 1980s and early 1990s. Many of these countries also have explicit or implicit deposit insurance and attendant safety and soundness regulations that give rise to moral hazard, as well as the other difficulties addressed in this chapter. As a result, there are important benefits to understanding the recent U.S. experience and the reforms that have evolved and are potentially applicable elsewhere.

COMMENT

V. GERARD COMIZIO[1]

This comment addresses the significant causes of the savings and loan crisis that occurred in the United States in the 1980s. For the U.S. Government and, more important, for U.S. taxpayers, the total cost of protecting insured depositors from loss as a consequence of savings and loan failures is currently estimated at $150–175 billion.[2] Thus, the savings and loan disaster raises significant public policy concerns in the United States. In fact, the U.S. Congress enacted legislation in 1990 establishing a national commission to examine the causes of the problems in the savings and loan industry and to make recommendations for avoiding a repetition of a similar crisis.[3] The sheer financial magnitude of the savings and loan debacle makes it crucial for the financial services industry, banking regulators, policymakers, and the public to understand its root causes.

Development of the Thrift Industry

The U.S. Government's approach to regulating savings and loan institutions was paternalistic and protective throughout most of the twentieth century. Home financing and the ability of all citizens to own homes were considered fundamental principles of American life. Because the Government viewed the savings and loan institutions as the facilitators of the goals of home lending and residential construction, the regulation of savings and loan institutions became an important aspect of public policy.

As noted in the report of the National Commission of Financial Institution Reform, Recovery, and Enforcement on the crisis (the National Commission Report), "[d]uring the 1930s, Congress transformed S&Ls into agents of national housing policy."[4] Federal deposit insurance was provided as a subsidy, allowing savings and loan institutions to raise large amounts of funds at less than market interest rates so that they could finance long-term, fixed-rate home mortgage loans. For the next 30 years, they admirably performed the role that Congress had assigned them of providing the financing for realizing the dream of home ownership. Government regulation sheltered savings and loan institutions from competition, allowing the industry to be profitable and failures to be rare. As long as interest rates did not rise substantially, savings and loan institutions faced little risk.

The National Commission Report points out that "[t]he modern savings and loan industry traces its origins to the Great Depression of the early 1930s, which brought default on 40 percent of the nation's $20 billion in home mortgages and the failure of some 1,700 of the nation's approximately 12,000 savings institutions."[5] At that time, Congress passed three statutes in order to stabilize the thrift industry. The Federal Home Loan Bank Act established the Federal Home Loan Bank Board (Bank Board), which was to channel funds to thrifts for loans on houses and to prevent foreclosures.[6] The Home Owners' Loan Act of 1933 gave the Bank Board authority to charter and regulate federal savings and loan associations.[7] The National Housing Act "created the Federal Savings and Loan Insurance Corporation, under the Bank Board's authority, with responsibility to insure thrift deposits and regulate all federally insured thrifts."[8]

Savings and loan associations proved popular, compared to banks. From 1946 to 1965, commercial banks grew at an average annual rate of approximately 5 percent, in contrast to growth of over 14 percent for savings and loan institutions.[9] The National Commission Report states:

> The stronger growth of S&Ls mirrored their ability to attract large amounts of deposits from the public to engage in profitable mortgage lending. Part of the advantage that S&Ls enjoyed over banks was a consequence of strong housing demand that made mortgage lending more profitable than business loans and other kinds of lending in which banks at that time specialized. But a good deal of the advantage had been bestowed on the industry by Congress to "compensate" them for the greater powers of banks.[10]

In the ensuing years, the U.S. Government encouraged the existence of thrift institutions and even, on occasion, provided them with a considerable competitive edge over other financial services competitors. For example, until 1954, savings and loan institutions paid no income tax. This exemption made their loans more profitable than bank loans, which were subject to income tax. More important, federal legislation in the mid-1960s gave thrifts a competitive advantage over commercial banks by allowing them to pay higher rates of interest on passbook savings accounts than permitted by law for banks. Later federal legislation also created "bad debt reserve" tax features for savings and loan institutions that virtually eliminated the need for thrifts to pay federal tax. In addition, other tax incentives favored thrifts over commercial banks in order to encourage the thrifts' mission of furthering home ownership.

The strategy of creating a more advantageous market for the thrift industry emerged as a notable aspect of the downfall of the savings and loan industry because, at critical points over the past 20 years, they were ill equipped to compete with emerging competitors in the mutual fund and money market industries.

Savings and loan executives sailed smoothly through the period following World War II and up to the 1970s. Their industry enjoyed a golden age, with total savings and loan assets expanding from $10 billion to $130 billion, 85 percent of which were mortgage loans.[11] Moreover, during the years between 1946 and 1965, the thrift industry enjoyed significant growth at an average annual rate of more than 14 percent.[12] In addition to high levels of savings, there was a great postwar demand for consumer goods and housing construction (in essence, pent-up demand), which the savings and loan industry served extraordinarily. As long as interest rates did not rise substantially, the business of savings and loan institutions faced little risk.[13] Accordingly, because interest rates remained fairly stable until the mid-1960s, the thrift industry faced no profound challenges.

Adversities in the Economy Significantly Altered the Course of the Thrift Industry

Accustomed to the comfortable complacency of the golden years of the thrift industry following World War II, thrift executives were ill prepared to confront the challenges that arose in the next 15 years. In the 1960s, two of the challenges—inflation and the resulting increase in interest rates in the domestic economy—had a severe impact on the portfolios of these institutions.

During the 1960s and 1970s, the overspecialized savings and loan industry experienced increasing risk and declining profitability, as rising interest rates and increased competition turned their environment increasingly hostile. Because deposit insurance shielded depositors from loss, however, the industry continued to expand. At a time when the industry needed to shrink and increase its capital levels, it did the opposite. Proposals to grant savings and loan institutions the flexibility to cope with mounting interest rate risk by granting the industry enhanced asset and liability powers were rejected repeatedly by Congress as inconsistent with national housing policy.

By 1979, inflation in the United States had reached double digits; as a result, the Board of Governors of the Federal Reserve System implemented a relentless anti-inflationary policy from October 1979 until October 1982. The severity of this policy produced a massive interest rate shock, bringing inflation quickly under control, but at high costs and to the detriment of the savings and loan industry.[14] At that time, adjustable-rate mortgages, which would have helped to alleviate the interest rate burden, were generally impermissible under federal banking and consumer laws, leaving earnings on mortgage loans at fixed rates. As a result, savings and loan portfolios, comprised primarily of fixed-rate mortgage

loans, sustained massive losses in market value, resulting in a combined negative net worth of approximately $150 billion.[15] Therefore, concern grew that as interest rates increased, the thrifts would have to offer higher rates to attract new depositors, while the bulk of their funds were already invested in long-term mortgage loans bearing the lower rates of the past.

As skyrocketing interest rates hit the industry's portfolios from one side, disintermediation in the American financial services community threatened the portfolios from another. Between 1966 and 1979, financial markets began to integrate, and many people came to believe that forced specialization of the various financial institutions should end; specifically, it was thought that savings and loan institutions should forsake their roles solely as home lenders so that they could diversify their assets and liabilities.[16] The U.S. Congress, however, insisted that the savings and loan industry continue in its capacity as a facilitator for home construction.[17] Furthermore, many in the thrift industry were reticent to relinquish the industry's niche in the financial services sector for fear of completely losing its integral position in the home lending market. Thus, savings and loan institutions continued as mortgage lenders, offering loans at low interest rates, while market interest rates continued to fluctuate and increase sharply.

Because nondepository institution competitors were able to pay market rates of interest on investments that were much higher than rates of interest paid on passbook savings accounts, savers drew down their deposits in the thrifts and placed them with competing mutual funds and money market funds, generating billions of dollars of outflows from thrift institutions. When market interest rates rose sharply in 1966, customers began to shift their investments into other market instruments that offered higher returns. By 1980, the thrift industry was in large part insolvent, its lending portfolio "underwater." Moreover, because of the changing facets of the financial services industry—specifically, rising interest rates and increased competition—the savings and loan industry faced an increasingly hostile environment.[18]

Government's Delayed Reaction to the Impending Thrift Crisis

Despite economic strife in the savings and loan industry, the U.S. Government, including the Congress, the Administration, and the various regulatory agencies, was slow to act. Statutory changes providing savings and loans with additional asset powers and complete deregulation of deposit interest rates had been recommended for several years. However, the government implemented the changes too late to successfully avert the savings and loan crisis.[19]

As a result, beginning in 1980, the Government sought to address and rectify the losses that several institutions had experienced, with the hope that interest rate fluctuations and any insolvencies would be short-lived. At that time, Congress moved to increase maximum deposit insurance levels from $20,000 to $100,000, in order to allay the crisis.[20] Furthermore, during 1981 and 1982, the Government introduced a policy of forbearance, under which institutions whose insolvencies were caused by unprecedented high interest rates were allowed to continue operating.[21] The philosophy driving these regulatory changes was that when interest rates returned to more normal levels, the industry also would return to solvency.[22]

Some elements of the 1980 legislation clearly had little effect. Some 415 savings and loans with $220 billion of assets had become insolvent.[23] In 1982, in addition to continuing its forbearance policies, Congress sought to resolve the crisis through the Garn-St. Germain Depository Institutions Act.[24] This act sought to enable the thrift industry to recoup the losses that it had accumulated as a home lender by allowing it to diversify and expand its nonhome lending activities. A deregulatory initiative, the Garn-St. Germain Depository Institutions Act significantly increased the authority of savings institutions to engage in nontraditional lending activities and riskier investments, including direct investment, increased commercial loan authority, real estate development, and interest rate speculation. At the same time, a number of states adopted similar legislation for state-chartered institutions. These states included Texas, Florida, and California, where a significant amount of the thrift industry's later losses would occur.[25] The problem arising in this instance was that the deregulation process of the thrift industry suffered a grave imbalance. The industry obtained substantial new investment powers and was subject to less supervision; simultaneously, government-backed deposit insurance was retained and even increased.[26] The disequilibrium, namely, greater risk and less supervision, which was underwritten at the expense of U.S. tax dollars, enhanced the chances of abuse in the industry and contributed significantly to the dissolution of the federal deposit insurance fund.[27]

The relaxation of supervision and regulation, coupled with the opportunity for higher risk endeavors and higher returns, led to a rapid expansion of the thrift industry between 1982 and 1985 that largely went unchecked by the respective regulatory agencies. In those years, industry assets ballooned 56 percent, increasing from $686 billion to over $1 trillion.[28] As this occurred, owners, operators, and managers of thrift institutions paid little heed to notions of safety and soundness (otherwise fundamental concepts in the federally insured financial industry). Rather, the minds of certain individuals in the industry became focused on reap-

ing great financial benefits, either to salvage their own institutions or, for some, simply to make a profit.

As rapid growth and large capital gains ensued, more potential thrift operators flocked to the various state and federal supervisors in order to charter their own institutions. Potential for gain in the thrift industry was immense, especially in light of the abatement of supervision and the likelihood that such supervision would not hinder efforts to gain substantial profits. At the expense of the federal deposit insurance fund, these new thrift operators were successful in their endeavors.

Effects of the Initial Governmental Response

By 1985, it was evident that the attempt at deregulation and diversification had been unsuccessful. The new thrift charter, with its significantly expanded range of activities, was an eagerly accepted invitation to responsible and irresponsible people alike to obtain thrift charters and to engage in the newly acquired and riskier activities. New regulatory actions expanded asset and liability powers of savings and loans sharply by allowing them to move into risky new areas of business in which they lacked expertise, while regulatory standards for safe and sound practices in these activities were virtually nonexistent.[29]

Consequently, the moral hazard became clear. An institution that was not healthy but had the opportunity to exercise the newly expanded powers had a further incentive to take risks. Specifically, because of the increase in insurance on depository accounts, owners and operators of savings and loan institutions had little of their own money to lose if the institution failed and much to gain by expanding.[30] On one hand, by taking risks for high rates of return, a savings and loan institution might manage to recapitalize itself. On the other hand, if its risks did not prove successful and the thrift became insolvent, the U.S. Government stood behind the deposit insurance funds and would absorb the losses. Savings and loan institutions and the thrift industry as a whole gambled on risks at the considerable expense of U.S. taxpayers. In essence, the moral hazard of deposit insurance was a "heads I win, tails you lose" philosophy for thrifts attempting to avoid failure.

Fraud in the Thrift Industry

While it was not the primary cause of the savings and loan debacle, unprecedented fraud emerged in the savings and loan industry as dishonest operators were attracted by the new governmental policies that provided the opportunity for such fraud.[31] The potential for profits was

notable, while, owing to diminished levels of supervision, the chances of getting caught were minimal.[32] Credit risk accumulated without the net worth to support it, and, with abusive practices proliferating, the savings and loan debacle emerged. The collapse of the real estate market that occurred in the latter half of the 1980s, especially in the southwestern part of the country, clearly compounded this crisis.

Unfortunately, new investment powers did not help thrift institutions recapitalize. Rather, new activities exacerbated losses as a result of the failure of several real estate projects throughout the Southwest. A number of large thrift institutions were intimately involved in the junk bond market, which turned out to be a disaster. When the junk bond market collapsed, portfolios evaporated.

Where Does Deposit Insurance Go From Here?

The events and circumstances that precipitated the savings and loan crisis provide a good basis upon which to evaluate new regulations and activities, or to implement an entirely new federal deposit insurance system, or both. Federal deposit insurance was a necessary condition for the debacle; in its absence, high-risk savings and loan institutions could not have developed. First, depositors would have demanded progressively higher interest rates as risks increased and ultimately would have withdrawn their funds. Second, raising the insurance limit to $100,000 exacerbated the situation, making available larger amounts of capital. These two factors "robbed the system of the market discipline needed to control risk."[33]

However, even in the best of circumstances, many savings and loans would have still failed in the early 1980s when 35 percent of the industry continued to sustain losses, 9 percent of all savings and loans were insolvent based on generally accepted accounting principles, and 16 percent were insolvent based on tangible net worth.[34] Clearly, in addition to the deposit insurance, other factors contributed to the profound taxpayer expense that followed. Had the Bank Board moved to close insolvent institutions in 1983, total costs to the taxpayer might not have exceeded $25 billion.[35] Furthermore, had the Bank Board stepped up its supervision and regulation, especially with respect to troubled institutions, many of the institutions would not have reached hopeless states of insolvency.[36]

By 1985, the Federal Savings and Loan Insurance Corporation maintained only $4.6 billion, while insolvencies had risen to $26 billion of total assets. Congress attempted to recapitalize the thrift industry insurance fund through the Competitive Equality Banking Act[37] in 1987. The Competitive Equality Banking Act allotted a very small amount, $10 bil-

lion, to recapitalize the Federal Savings and Loan Insurance Corporation fund. By 1988, it became apparent that this amount was insufficient and that a major financial disaster was imminent.

As a result, the landmark savings and loan bailout legislation, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA),[38] attempted to forge a new resolution to the crisis. This legislation released massive amounts of taxpayer monies to fund the bailout and the resolution of up to 800 insolvent thrift institutions. FIRREA accounted for estimates by 1989 that the cost of a savings and loan bailout would exceed $100 billion. The legislation also significantly changed the regulation of savings institutions by requiring them to revert to home lending and to disengage from the direct investment and commercial lending activities granted by federal and state legislation in the 1980s.

In response to the perceived problem associated with deregulation of the thrift industry and the circumstances that arose therefrom, banking legislation since FIRREA has imposed additional operating restrictions upon both banks and thrift institutions by significantly increasing regulatory capital requirements and by significantly augmenting the regulatory oversight of the Federal Deposit Insurance Corporation. Post-FIRREA legislation also has reinforced the power of the U.S. federal banking agencies, so that those agencies can literally take over and run the business of undercapitalized banks or savings and loan institutions until capital problems are solved.

The Future

At present, the American banking community seeks to increase its securities, insurance, and other nontraditional banking activities. There are good public policy reasons, including the enhancement of the competitive position of banks, underpinning the revisiting of earlier legislation limiting these activities that was passed during the U.S. banking crisis of the 1930s. However, to some degree the savings and loan debacle continues to cast its shadow whenever Congress addresses these issues. In evaluating new activities and risks, and in determining a new course of action for any federally insured industry, the question always will arise as to how and to what extent the proposed new activities will increase the risk to the federal deposit insurance funds.

This issue becomes especially acute for legislators and banking regulators in dealing with the proliferation of other nondepository financial institution competitors. These nondepository institutions, such as mutual funds and securities firms, have been and will remain formidable bank competitors for retail funds.

Indeed, the members of the American banking industry intend to continue to demand changes that will allow for diversification of permissible activities. Thus, in the future, the primary issue on the legislative agenda will be the consideration of appropriate safeguards to protect against dangers to the deposit insurance funds. The regulatory agencies and the public policy discussions have proposed the establishment of so-called firewall safeguards between nondepository and depository activities; only the latter would be backed by the full faith and credit of the U.S. government by means of deposit insurance. If regulatory agencies start a trend toward deregulation and if diversification continues, the issue of firewalls will be a significant part of the dialogue, both within the regulatory agencies and in Congress, in light of the savings and loan crisis.

Chapter

21 Bankruptcy: Policy, Law, and Strategy

21A. Bankruptcy Policies, Restructuring, and Economic Efficiency

IZAK ATIYAS

Introduction

The importance of bankruptcy laws for the development of debt instruments, as well as for financial markets in general, is well-known. Bankruptcy policies establish a formal procedure that may be initiated whenever a debtor is unable to meet contractual obligations to creditors. The procedure is designed to redistribute the rights to control the debtor firm and the rights to appropriate the income stream generated by it. When properly designed and implemented, bankruptcy mechanisms are believed to enhance economic efficiency by allowing the timely exit of unproductive economic units and regulating the transfer of the ownership of productive assets to more qualified entrepreneurs. Inadequate bankruptcy mechanisms, however, may cause excessive liquidation of assets or act as barriers to exit.

Bankruptcy procedures also make up an important component of countries' policies for industrial restructuring. In many countries, insufficient capital mobility acts as a significant barrier that delays or hinders efficient restructuring. Many developed and developing countries have designed policies within given sets of rules to address the special problems of declining industries, and to remove barriers to capital mobility and exit.[1] Such policies attempt to facilitate restructuring, including through capacity reduction, enterprise rehabilitation, or exit. Bankruptcy procedures can be seen as an important component of these policies.

Most bankruptcy laws prescribe variants of two distinct procedures. In the first procedure, bankruptcy liquidation, the debtors' assets are sold, and the proceeds are divided among creditors according to sharing rules that are determined by lawmakers. The second procedure, bankruptcy reorganization, is a process under the supervision of the court in which the claimholders of the debtor firm negotiate the restructuring of the debtor's liabilities and assets, possibly with the objec-

tive of maintaining the company as a going concern. Negotiation is successful if an agreement is reached. The agreement may stipulate either the continuation of the firm as a going concern in restructured form or, in principle, its liquidation. If no agreement is reached, the reorganization process fails, and, most likely, bankruptcy liquidation proceedings are initiated.

Bankruptcy reorganization procedures potentially play an important role in rehabilitating companies that are in financial distress and in default on debt payments. Rehabilitating such companies often entails restructuring the assets and claims on the enterprise. Firms in need of restructuring are often overindebted because of past macroeconomic policies that encouraged debt accumulation, earnings shocks that generated losses and reduced equity capital, or bad management. These firms often also need to reorganize their assets to increase productivity. Hence, a regulated process of debt renegotiation and asset reorganization may play an important role in industrial restructuring.

Depending on how they are designed, reorganization procedures may also act as barriers to exit, for example, by granting debtors too much protection. When debtors are granted excessive bargaining power during reorganization negotiations, they may abuse the process to delay exit or extract economically unjustified concessions from creditors. Therefore, the mechanisms designed in reorganization to resolve conflicts of interest between debtors and creditors, in particular the distribution of rights to control the enterprise's assets during reorganization negotiations, are essential determinants of not only the economic efficiency of the outcomes but also the extent to which bankruptcy laws can play a useful role in industrial restructuring.

Attempts to design or reform bankruptcy laws are often confronted with the following questions: Should bankruptcy policies allow for bankruptcy reorganization? If so, to what extent should bankruptcy policies "protect" debtors; in other words, how should control rights be distributed during reorganization? How should bankruptcy policies in developing countries take account of such structural characteristics as weak judicial systems and underdeveloped capital markets?

The next section of this paper discusses some market imperfections that provide the economic rationale for bankruptcy (especially reorganization) policies. The following sections present an international comparison of bankruptcy laws and some thoughts on bankruptcy policies for developing countries.[2]

The Economics of Bankruptcy Policies: Common Pool and Agency Problems

An important economic function of the state in capitalist economies is to enforce contracts or impose damages or penalties on the party that breaches a contract. In the case of debt contracts, a breach occurs when the borrower does not repay the debtor. When a debtor defaults on a loan, the creditor has generally two options outside bankruptcy. If the loan is secured, the creditor can have resort to the security by seizing the assets that serve as collateral. If the loan is not secured, the creditor can pursue other legal action permissible under debt-collection laws. For example, in the United States, the creditor can sue the debtor; if successful, the creditor may foreclose on real property or seize personal property.[3]

However, these methods of enforcing loan contracts become inadequate when the number of creditors is large, and especially when the value of the debtor's assets is inadequate to pay all claims. Typically, debt-collection laws function on a first-come, first-served basis. Under these conditions, a coordination problem arises, as each creditor rushes to seize assets before the others, resulting in a fragmentation of the debtor's assets, which is costly if the firm is worth more as a whole than as the sum of its individual assets. It has been argued, therefore, that a coordinated settlement of claims through a bankruptcy procedure may be in the interest of the creditors as a whole. Hence, the main purpose of the bankruptcy policy can be seen as solving the "common pool" problem.[4] Bankruptcy typically resolves common pool problems by triggering an "automatic stay," that is, by forbidding creditors from grabbing assets through individual debt-collection action.

The common pool problem has an important variant in the case of firms that suffer from debt overhang. When creditors cannot perfectly monitor the actions of a borrower, it may be in their interest as a whole to reduce the face value of the claims on an overindebted firm; by providing better incentives to the firm and, therefore, enhancing efficiency, debt reduction may increase the value of the remaining stock of debt claims. However, the common pool problem may prevent such a debt reduction, even when it is an efficient outcome. No single creditor may have an incentive to reduce the face value of his or her claim; each individual creditor bears the cost, while other creditors are seen to benefit from the efficiency gain. Rehabilitation of the debtor through debt reduction may require a collective action that may not be possible to implement through the market mechanism. A bankruptcy reorganization

procedure may provide a forum in which such collective action can take place.

While the common pool problem is seen as an important economic justification for bankruptcy policies, conflicts of interest between creditors and debtors pose another major problem that bankruptcy policies must address. In environments where bankruptcy is an underlying concern, these conflicts of interest, or "agency problems," arise because debtors are typically interested in maximizing the equity value rather than the total value of the firm, even though actions that are conducive to that objective typically may reduce the value of debt.[5] Several examples of such activities have been given in the literature.[6] In principle, such agency problems could be resolved if covenants could be included in the debt contract that would state contingent actions that the borrowers would undertake ex post. However, creditors often cannot perfectly monitor the actions of debtors after a debt contract is written because of such problems as imperfect information and the costliness of contract enforcement.

These conflicts are magnified during periods of financial distress, when the value of the owners' stake in the debtor company is diminished. This situation reinforces equity holders' incentives to transfer wealth from creditors by, for example, taking on excessive risk, assuming new (especially secured) debt, stripping assets, or even conveying them to third parties for personal gain. These incentives make the renegotiation of claims on the enterprise more difficult.

In principle, bankruptcy policies should address agency problems by generating incentives to maximize the net value of the assets involved. In particular, the rules should ensure that debtor companies liquidate, continue operation, or reorganize whenever it is socially optimal to do so.[7] The rules should also encourage the maximization of the value of the assets under bankruptcy without jeopardizing the terms of the original debt contracts. Striking a balance between promoting the restructuring of viable firms and protecting creditors' rights is one of the most difficult issues in bankruptcy law design.

Bankruptcy policies set the rules to be followed under liquidation and reorganization, and establish the options available to the parties. These policies determine who has the right to initiate bankruptcy proceedings; they also set priorities among different types of creditors upon liquidation of the debtor's assets, lay down procedures to be followed during liquidation, establish the degree to which contracts established prior to bankruptcy can be voided, and determine the extent of the protection granted to the debtor's assets from legal actions undertaken by the creditors. Furthermore, bankruptcy policies determine the manner in which debtor and creditors can jointly exercise control over the firms' assets

under a reorganization process, choose the parties that are authorized to prepare a reorganization plan, establish the voting rules whereby the different classes of creditors can approve an agreement for reorganization, and set the degree to which secured creditors' claims can be reduced. In addition, bankruptcy policies define the role of the government and the role of courts in the process.

Variations in Bankruptcy Policies Across Countries

Different countries have taken different approaches to resolving the common pool and agency problems. They have also struck different balances between protecting creditors' rights and encouraging restructuring.

United States

In the U.S. reorganization procedure, which is governed by Chapter 11 of the Bankruptcy Code,[8] debtors retain significant control rights and substantial bargaining power during negotiations. The debtor remains in possession of the assets and continues managing them unless the court finds it necessary to appoint a trustee. The debtor also has the authority to design and propose a reorganization plan. Recent empirical studies, as well as evidence of a more anecdotal nature, suggest that these features of the legal framework allow debtors to extract significant concessions from creditors.[9] In particular, shareholders and management can threaten creditors by delaying the bankruptcy process. If the net value of the assets has fallen and the value of equity is close to zero, delays impose losses on creditors but not on the shareholders, who basically have nothing to lose.

United Kingdom

Whereas the bankruptcy legislation in the United Kingdom prior to 1986 emphasized winding-up over reorganizations, the Insolvency Act, 1986, provides two mechanisms for debtors' rehabilitation: administration and administrative receivership.[10] The basic duty of an administrator, who is appointed by the court, is to take over the management of the company, prepare proposals for its rehabilitation, and carry out these proposals.[11] The administrator has wide administrative and management powers.

An administrative receiver has functions similar to those of an administrator, except that it is appointed by holders of debentures secured by a floating charge, rather than by the court.[12] The authorities of the administrative receiver include those granted to the administrator, as well as any additional authority envisaged in the debenture. Under the U.K. legisla-

tion, therefore, in contrast to the U.S. legislation, the incumbent management loses control over the assets of the company.[13] More important, holders of debentures secured by floating charges may pre-empt the appointment of an administrator by appointing an administrative receiver. By exercising that prerogative, secured creditors dominate the process.

France

The French legislation[14] is explicitly designed to save the debtor's enterprise and labor force, as well as to discharge all liabilities. It is different from the bankruptcy laws in the United States and the United Kingdom in that it prescribes a single bankruptcy procedure involving several stages. First, except when the enterprise has ceased all activities or when its rehabilitation is obviously not possible, all bankruptcy proceedings begin with a period of observation, during which an economic and financial account is drawn up and a rehabilitation plan—setting forth proposals either to continue or to transfer the enterprise's activities—is prepared. Then, before the period of observation expires, the court either adopts the proposed plan or, if no continuation or transfer is possible, declares a judicial liquidation of the debtor enterprise.

The court initiates a bankruptcy proceeding by appointing an administrator, whose functions include the preparation of the economic and financial account, as well as the plan of rehabilitation. The legislation assigns substantial decision-making power to the court. For example, it is up to the court to decide whether the administrator will merely oversee management operations, assist the debtor in current management activities, or take full control of the enterprise. It is possible for the court to decide that the debtor is totally divested of all rights pertaining to management of the enterprise and disposition of assets. Furthermore, the legislation allows the court to adopt the proposed rehabilitation plan even if the debtor, the creditors, or the workers' representatives object. In a reform in 1994, the protection of secured creditors was strengthened somewhat, but the dominant position of the court was left fundamentally intact.

Comparison of Bankruptcy Laws in the United States, the United Kingdom, and France

There is general agreement that bankruptcy codes should include reorganization as an option. The question then is, To what extent should the bankruptcy process protect debtors? For example, should the debtor retain the right to control the firm's assets under bankruptcy? How

should bankruptcy reorganization be designed so that it encourages the restructuring of viable firms without jeopardizing the creditors' rights?

The U.S. Bankruptcy Code appears to have incentives to delay and defer liquidation, especially by granting the debtor the ability to impose costs on creditors by delaying the process; the U.K. Insolvency Act, by contrast, may prompt premature liquidations by emphasizing only the rights of creditors—and, in most cases, the rights of only secured creditors. Also, the U.S. Bankruptcy Code frequently tends neither to help uphold the original debt contracts nor to protect creditors' contractual rights by allowing outcomes that transfer wealth from creditors to debtors; by contrast, the receivership in the U.K. Insolvency Act results in a speedy settlement of claims. Also, by giving priority to new financing, the U.S. Bankruptcy Code perhaps facilitates access to new financing at the expense of a higher ex ante cost of capital. In summary, both laws are imperfect in terms of economic incentives.

The French system has chosen another approach by granting substantial decision-making authority to the court and judges, rather than to the creditor or the debtor. The problem with this approach is that the court may not have any incentive to act in a way that would maximize the value of the firm. Because the decisions of the court, which has no stake in the process, dominate those of other parties who do have a stake in the process, bankruptcy outcomes may be inefficient and fail to protect creditors' rights.

A better balance may be reached by, on the one hand, requiring that the debtor lose control rights once the company is under bankruptcy and, on the other, not granting control rights or decision-making authority to one set of creditors at the expense of others. This approach would require granting a substantial role to a trustee or an administrator, as in the U.K. system, while curtailing the veto power of secured creditors.

Problems of Bankruptcy Policy in Developing Countries

Bankruptcy policy in developing countries faces additional problems.[15] First, in many cases, the law itself is outdated. It does not sufficiently differentiate between the enterprise and its owners and managers, so that rehabilitation of the enterprise as a going concern almost always implies that the owners must be bailed out as well. This lack of differentiation limits the flexibility of the process and restricts the number of options. Moreover, in many countries, bankruptcy has criminal implications, a problem that unnecessarily increases the stigma attached to going bankrupt. Second, there are problems of institutional and financial infrastructure. The processing capacity of the court system, as well as the

number of expert bankruptcy practitioners, is limited. Judges are often inexperienced in dealing with conflicts that arise from financial and commercial transactions. In addition, information dissemination and legal documentation in the financial system may be imperfect if accounting and disclosure rules are inadequate.

These features might suggest that bankruptcy procedures in developing countries should not require extensive judgments and evaluations from the court system, and that reorganization procedures are more likely to produce efficient outcomes if, during negotiations, creditors or their representatives are able to control the activities of the debtor firm, including by taking over its management. However, the latter conclusion needs to be qualified. First, in many developing countries, banking systems are oligopolistic; collusive behavior among banks is widespread. Granting banks a dominant role under bankruptcy would not lead to competitive solutions and might possibly encourage abusive behavior on their part. Second, banks are often owned by conglomerates that hold industrial interests as well. In these circumstances, the bankruptcy process may be used to increase the dominant market positions of conglomerates at the expense of firms that are not members of conglomerates. The policy implication would seem to be that, in order to produce efficient results, a reform that would introduce a creditor-oriented bankruptcy law should be preceded by the establishment and effective implementation of competition policies.

In a recent reform of bankruptcy procedures in Colombia, a different approach was taken: the Superintendency of Companies, an administrative body, was granted judicial powers and made the sole competent body overseeing the bankruptcy and reorganization of large companies. The bargaining power of debtors was curtailed by imposing tight time limits on the different stages of the bankruptcy process. In addition, the technical and financial expertise of the Superintendency was enhanced through the hiring of additional financial experts. The Superintendency of Companies now analyzes bankruptcy reorganization primarily as an economic and business problem, rather than as a purely legal problem. Preliminary empirical evidence suggests that these changes have actually improved the procedures, which take less time than before.

Conclusion

The bankruptcy process is a mechanism that is used as a last resort in corporate restructuring. It should be seen as one of a multitude of available mechanisms promoting restructuring in the industrial sector. Informal reorganizations, undertaken out of court with the participation

of agents that specialize in corporate workouts, is an important complement to formal bankruptcy procedures. Informal workouts are less costly than formal bankruptcy reorganizations. They work best when the number of creditors with claims to be reorganized is relatively small. The disadvantage is that informal workouts require the consent of all creditors in that particular class, whereas formal bankruptcy often requires the consent of some fraction of the creditors. Hence, when the number of creditors is large, it is more difficult to resolve the common pool problem in informal workouts, and formal bankruptcy may be necessary.

Finally, it should be noted that restructuring is in many countries impeded by important shortcomings of the general regulatory environment, such as restrictions on the mobility of capital and labor and inadequacies of the social safety net. Unless undertaken as part of a general overhaul of the regulatory environment aimed at eliminating these shortcomings, a reform of the bankruptcy system alone is bound to be ineffective.

21B. An Explanation of, and Guide to, Business Reorganizations Under Chapter 11 of the U.S. Bankruptcy Code

ROGER M. WHELAN

Introduction

An important aspect of the U.S. bankruptcy system is the emphasis and importance placed on financial rehabilitation—both for individuals and businesses. Chapter 11 of the Bankruptcy Code,[1] which generally pertains to business reorganization, is a special relief chapter of the Bankruptcy Code; only persons (individuals, partnerships, or corporations) who are otherwise eligible for relief under Chapter 7 of the code (the special relief liquidation chapter of the code) may seek relief under this chapter. There is, however, no requirement that the person seeking relief under Chapter 11 be insolvent.[2]

Because of the cyclical nature of the business economy and the diverse types of business problems that have arisen in the past few decades, numerous businesses, ranging from small, single-asset real estate cases[3] to multinational corporations, have successfully sought relief under the wide-ranging provisions of Chapter 11. Essentially, the goals of Chapter 11 are (i) to provide a statutory framework within which a debtor may formulate a plan of reorganization resulting in a broad discharge of indebtedness and other protective devices that will enable the business to continue its operations or, alternatively, (ii) to provide an organized plan of liquidation in order to maximize the going-concern value of the failed business for its creditor constituency.

In the first instance, the filing of a Chapter 11 case (primarily consisting of a petition seeking relief under Chapter 11, detailed schedules setting forth a complete and comprehensive description of assets and claims, an exhibit setting forth a summary of the financial structure of the debtor, and detailed answers dealing with various aspects of the debtor's financial transactions) triggers the imposition of an "automatic stay," which, subject to certain defined exceptions, creates a court-imposed moratorium on adverse actions pending or threatened against the debtor or the debtor's property.[4]

An important development in many Chapter 11 cases is the appointment and role of the unsecured creditors' committee. In addition, for partnerships or corporations, an equity security holders' committee may also be appointed. The Office of the U.S. Trustee, acting independently

of the court, will appoint a representative creditor committee, usually drawn from the 20 largest unsecured creditors and consisting of 3–5 members. This committee may retain counsel, and the expenses of the committee members incurred in connection with the performance of their duties are subject to reimbursement from the debtor's estate. The committee possesses broad powers of inquiry and provides input during the ongoing phases of the debtor's business operations. The committee also has legal authority to assert and pursue individual causes of action to enhance the estate if the debtor fails or refuses to pursue such actions. If the debtor's management has engaged in fraud, gross mismanagement, or essentially any conduct constituting "cause," the bankruptcy court may oust the "debtor in possession" (the new legal entity created by the filing of the Chapter 11 petition) and order the appointment of an independent trustee to render and investigate the debtor's conduct. The appointment of an independent trustee will also result in recommendations concerning the debtor's future business operations in the Chapter 11 case.[5]

Rights and Powers of Debtors in Possession

During every Chapter 11 case, the debtor in possession has all the rights and powers of a trustee. These rights and powers are set forth as follows:

Right to Reject or Assume Executory Contracts[6] or Unexpired Leases

The right to reject or assume executory contracts or unexpired leases is an important aspect of all bankruptcy law. On the one hand, it enables the debtor in possession to rid itself of burdensome contracts or leases, subject only to the right of the nondebtor party to file a claim for damages sustained as a result of this breach; on the other hand, the debtor, in those cases in which a decision was made to derive the benefits of an advantageous executory contract, has the right to assume such a contract, even where there was an existing default, subject only to the debtor's obligation to cure existing defaults, compensate the nondebtor party for actual damages sustained as a result of the prepetition breach, and provide assurance of future performance.

Right to Avoid or Annul Certain Prepetition Transactions

The right to avoid or annul prepetition transactions most frequently asserted pertains to certain transfers of the debtor's property that were

preferentially made to satisfy, in whole or in part, a prepetition antecedent debt within 90 days prior to the filing of the Chapter 11 case.[7] The recovery of a preference will enlarge the estate for the benefit of all unsecured creditors. Other rights asserted by debtors include the right to avoid or recover property that was fraudulently transferred prior to bankruptcy, as well as property of the estate transferred subsequent to the date of bankruptcy unless authorized by the bankruptcy court; the right to avoid certain types of statutory liens that were triggered prior to bankruptcy by the debtor's insolvency; and finally, the right to avoid any type of security interest that was not properly perfected as of the date of bankruptcy.

Right to Use, Sell, or Lease Property of the Estate

The debtor is usually free to sell property of the estate that is employed in the ordinary course of the debtor's business (for example, inventory), as long as the sale occurs in the ordinary course of business. Sales of property outside the ordinary course may also occur, but only after notice is given and hearing held, and if certain statutory conditions are present. For example, if the debtor possesses a margin of equity in a given asset, that asset may be sold free and clear of all liens, claims, and encumbrances, with the proceeds of sale subject to any prior perfected security interest.

Right to Obtain Secured or Unsecured Credit

In the ordinary course of the debtor's business, all extensions of unsecured credit will be allowed as an administrative expense. Through this right, the unsecured creditor is entitled to a first-priority right of payment in advance of the debtor's other prepetition unsecured creditors. Envisaging that the debtor may otherwise be unable to obtain unsecured credit to finance its business operations, the Bankruptcy Code thus grants to the prospective creditor a super priority, or lien, on the debtor's property.[8]

Right to Secure Turnover of Estate Property Seized by a Creditor Prior to the Chapter 11 Case

An important aspect of bankruptcy law—and one frequently employed in Chapter 11 cases—is the statutorily created right to seek a turnover of estate property whenever such property was lawfully seized by a creditor prior to the commencement of the case. If the seizure applies to property of the debtor's estate and if the creditor's security interest is not subject to avoidance in the bankruptcy case (namely, subject to one of the debtor's avoiding powers explained previously), the debtor is entitled to

a return of that property, subject only to providing "adequate protection" to the creditor.

Rights of Creditors

In order to balance the debtor's rights available in a Chapter 11 case, the creditors also have rights and protections that are statutorily created. While unsecured creditors (namely, those creditors who lack some form of lien right, such as a consensual, judicial, or statutory lien) generally must await the confirmation of the debtor's plan of reorganization before receiving any distribution with respect to their claims,[9] secured creditors (for example, creditors asserting foreclosure rights against the debtor's real estate) may have the right to seek relief from the broad effects of the automatic stay. In other words, secured creditors are entitled to receive adequate protection for their security interest;[10] in the absence of such protection, the bankruptcy court may modify or annul the stay.[11]

Plan of Reorganization

The debtor in possession is required to file a plan of reorganization within the first 120 days after the Chapter 11 case has been initiated. This period of debtor exclusivity is, however, subject to either being shortened or extended, depending on the unique facts of the Chapter 11 case. In most significant cases (such as those involving large, publicly held corporations), extensions will usually be granted, within which period only the debtor enjoys the right to file a plan of reorganization. If exclusivity has expired or has been terminated by the court, any party in interest may file a plan.

As a matter of both substance and procedure, the plan of reorganization must be accompanied by a disclosure statement that sets forth "adequate information" for the benefit of a "hypothetical reasonable investor." The plan document must also define classes of creditors and comply with specific statutory requirements. The disclosure statement represents a critical point in the progress of the Chapter 11 case because the court must approve this statement before either it or the debtor's plan can be disseminated. In fact, neither acceptances nor rejections of the plan can be solicited prior to the bankruptcy court's approval of such a disclosure statement.[12]

Confirmation of the Plan

In order to secure confirmation of the plan, the debtor must secure a simple majority in number and a two-thirds majority in dollar amount of

all creditors within a given class. Assuming that the acceptance standards have been complied with, the debtor can then seek confirmation of its plan of reorganization.[13]

The confirmation hearing is conducted by the U.S. Bankruptcy Judge, who must make a determination that all statutory requirements have been complied with by the debtor. Essentially, these statutory requirements are set forth and explained as follows:

- The plan complies with all plan provisions set forth under the code, and the proponent of the plan has complied with all such provisions.
- The plan is one proposed in good faith and does not involve "any means forbidden by law."
- Full disclosure has been made for all payments that are to be made, and all payments for services, costs, or expenses have been approved by the bankruptcy court.
- Full disclosure has been made as to the identity and affiliations of the debtor, and the plan sets forth certain required information with regard to post-confirmation management.
- Where necessary, and where rates are involved, government regulatory approval has been secured.
- With respect to any impaired class of claims, each individual claimant must have accepted the plan, or there must be evidence that the claimants will receive at least what would be received in a Chapter 7 (liquidation) case.
- Each class of claims set forth in the plan has accepted or is deemed to be unimpaired under the plan.[14]
- Special payment provisions will be made for defined priority claims, which will usually require payment in full or, in the case of tax claims, deferred payments over a six-year period.
- Where claims are impaired under the debtor's plan, there should be at least one accepting noninsider class.
- An express finding has been made by the bankruptcy court that the plan is feasible and is not likely to be followed by liquidation or require the need for further financial reorganization (except where the debtor's plan is one of liquidation).
- All required fees to the U.S. Trustee have been paid.
- Special protective rights owed to retirees will be continued under the plan.

However, if a certain class of creditors has not accepted the debtor's plan of reorganization,[15] and as long as there is at least one accepting noninsider class of claims, the debtor may attempt to obtain a "cram down" of the plan against the dissenting creditor class. A cram down essentially requires that the bankruptcy court find the plan of reorganization to be "fair and equitable" and not unfairly discriminatory with respect to any class of creditors.

Confirmation of the plan effects a broad discharge for the debtor of all claims arising prior to the confirmation order and causes all property interests to be vested in the debtor pursuant to the provisions of the plan. Subject to statutorily created exceptions (for example, where the debtor has filed a plan of liquidation and will no longer remain in business subsequent to the Chapter 11 confirmation date), the legal effect of a Chapter 11 discharge is broad in scope and affects all creditors, regardless of their acceptance or claims status.

Conclusion

The framework of Chapter 11 of the U.S. Bankruptcy Code is based on several important legal principles, all of which stress the need for (i) a legally imposed moratorium, within which creditors are compelled to desist from any action or legal proceeding that affects the debtor or its property; (ii) full and adequate disclosure of all relevant information to creditors; and (iii) meaningful participation of creditor or equity security holders in the case through formal committees. In addition, the Bankruptcy Code establishes (i) the ability of the debtor to reject burdensome executory contracts or to assume without penalty contracts that are advantageous; (ii) the ability of the debtor to secure debtor-in-possession financing in order to continue necessary business operations; and (iii) the ability to bind dissenting creditors subject to the acceptance and cram down standards set forth under the Bankruptcy Code. At the same time, the Bankruptcy Code recognizes that creditor rights must be considered and protected; accordingly, it encourages and provides creditors with powerful statutory rights (for example, participatory rights as a committee, strict but flexible notice of hearing requirements binding on the debtor, strict disclosure requirements with respect to the formulation of a plan, and rights to recover previously transferred property in violation of certain code sections).

For most of the major national and transnational corporations that have been compelled to seek relief under Chapter 11, the rehabilitative provisions of the bankruptcy law not only have resulted in successful reorganizations but have saved countless jobs, provided a significant return to

creditors, including taxing authorities, and enabled the debtors to preserve the going-concern value of their businesses. Unfortunately, because of the expense and delay inherent in the legal process, most small businesses have not fared so well.[16] Nevertheless, Chapter 11 remains one of the most important economic safety nets in the U.S. legal system today.

21C. Bankruptcy Law and Bank Insolvency Law in Eastern Europe

HENRY N. SCHIFFMAN

Bankruptcy Law

This chapter first addresses aspects of bankruptcy law in Eastern Europe.[1] Key provisions of bankruptcy or insolvency law focus on administrative efficiency, the stay of related proceedings, priorities in the distribution of assets, the degree of finality of the proceedings, enterprise rehabilitation, and the voidance of certain prebankruptcy transfers.

Regarding the efficiency of the administration of insolvency proceedings, the law of the Czech Republic contains a model provision granting appropriate discretion to the court in supervising the trustee[2] and affirming that there is no right of appeal against the court supervision of the proceeding.[3] A difficult question in this connection involves the effect of bankruptcy proceedings on enterprises that are to be privatized. The Czech Republic has attempted to come to grips with this question in proposing some amendments to the bankruptcy law. However, the amendments are complicated and may be impractical in some cases. There does not appear to be a full consideration of the sale of assets, as distinguished from the sale of an enterprise, or of how an impending bankruptcy proceeding would affect the prospective investors and the company to be privatized. A request for initiating a bankruptcy proceeding against a company involved in privatization may be stayed for different periods of time, according to this proposal, depending upon the stage of the privatization process.

The stay of collection actions against a debtor, a process described as the "rush to the courthouse," may be the most important provision in a bankruptcy law. Under Hungary's law, however, a stay does not automatically arise when a reorganization petition is filed. A debtor must meet with creditors within 15 days of filing a reorganization proposal, and a certain percentage of the creditors must agree to the stay.[4]

With respect to the distribution of assets, a train of thought in European bankruptcy law reform suggests that setting priorities in the distribution of assets among unsecured creditors should be minimized. This line of thought is apparently based on the belief that, as there really is no "natural law" governing the appropriate distribution of assets, few priorities should be set, so that the creditors in a collective proceeding can share the assets pro rata. This approach would probably facilitate the

granting of unsecured credit. Among unsecured claims, the Czech, Hungarian, and Polish laws give priority in the payment of claims to the administrative expenses of the bankruptcy proceedings, which is appropriate. Indeed, if a trustee is not assured that the costs and fees of administering the estate will be paid, the bankruptcy proceeding will not be administered by responsible persons. Employee and government claims are generally next in payment priority. In this connection, the new thinking is that priority should not be given to workers' claims if there is a system of social security. Tax claims' priority may be somewhat illusory because granting such priority means that creditors who receive no dividends will have tax-deductible losses that will reduce their tax payments. None of the laws appear to give priority to those who provide credit after the commencement of bankruptcy proceedings. This omission will diminish the prospects of restructuring some enterprises because they will have to curtail business activities that depend on new credit.

With respect to the degree of finality of the resolution of claims against debtors in insolvency proceedings, one of the important goals in some countries is providing a debtor with an opportunity for a fresh start. In a market economy, entrepreneurial risk is to be encouraged because successful new business ventures benefit the economy and society. The penalty of failure should not be so great as to discourage risk taking. If a businessperson were to be barred for life from engaging in business or never to be free of business debts, risk taking would be limited. In Eastern European countries, many businesses are in the form of unincorporated single proprietorships. Consequently, involvement in bankruptcy proceedings has more consequences for future business activities than in countries in which limited liability corporate businesses are more prevalent.

Under Hungarian law, if a certain percentage of creditors in a reorganization proceeding approve the plan, all creditors are bound by it, as long as those not accepting the plan receive treatment equal to or better than that accorded those who approved it.[5] Under Poland's law, liquidation proceedings do not finally settle all claims against the debtor.[6] Claims not recognized in the bankruptcy action may be brought against the debtor after the bankruptcy proceedings are concluded.[7]

Regarding enterprise rehabilitation, Hungarian law tends to encourage financial reorganization of insolvent enterprises as a serious alternative to liquidation. Bankruptcy laws that do not have comprehensive provisions to encourage financial reorganization, such as those in the Czech Republic and Poland, embody a policy that, in effect, promotes the liquidation of enterprises when their current liabilities cannot be met,

regardless of their degree of negative net worth or the remediability of the situation.

It is too early to say whether the discretion given to courts under the insolvency laws of Poland and the Czech Republic to reject settlements on reorganization agreed to by debtor and creditors will significantly limit the utility of reorganization provisions; nevertheless, this is a possibility. Clearly, the arbitrary provisions in the laws of the Czech Republic setting a minimum of claims payments by the debtor to conclude a settlement will restrict the use of reorganization as an alternative to liquidation. Similarly, with respect to the confirmation of settlements, courts in both the Czech Republic and Poland may refuse to confirm settlements agreed to by the creditors and the debtor if they determine that the proposal is too disadvantageous to dissenting creditors. Again, the court should be careful about substituting its own judgment for that of the parties to the proceeding, especially on such indefinite criteria, as the alternative in many cases will be liquidation.

Regarding the voidance of prebankruptcy transfers and payments, the law should as a matter of fairness—and to encourage creditors not to be unduly concerned about extending credit—provide that payments made by a debtor to creditors during some period before bankruptcy be null and void. These funds would then become part of the estate, to be apportioned among all creditors in the reorganization. Debtors should not be able to choose who will get paid in full and who in part or not at all; this is a general principle in bankruptcy law—equitable treatment of all creditors similarly situated. However, none of the laws under consideration contain general provisions that void preferences given to creditors within a certain time period before bankruptcy. Some laws void transfers made gratuitously, while others void transfers made to family members, for security interests, or as payments.

Bank Insolvency Law

In the complex area of bank insolvency and involuntary bank liquidation, the laws are rather diverse in Eastern Europe. Under one country's banking law, no special provisions are made for the insolvency of a bank, which means that the issue is left to the general bankruptcy law.

There is an important question of whether a general bankruptcy law would be appropriate for a bank. Because regulatory considerations are paramount in the reorganization—as opposed to the liquidation—of a bank, it would seem that a bankruptcy law may not be adequate. Of course, when it comes to liquidating a bank, a good bankruptcy law could be applicable because liquidation is a much more mechanical process,

comprising essentially receiving and verifying claims, selling assets, and distributing the proceeds. However, when it comes to finding new shareholders for a troubled bank, getting new equity capital, or taking out bad assets, the banking authorities should be involved to a significant extent; their judgment on such matters as the suitability of new principal shareholders or the feasibility of merging a strong bank with a weak bank should be determinative.

Under another country's law, insolvency proceedings can be initiated either by the central bank or by creditors of the bank. The desirability of creditors' action in this area is questionable. Initiating an insolvency proceeding for a bank is such a delicate matter that perhaps it should be left only to the bank supervisor, as the formal questioning of a bank's financial integrity by private parties could exacerbate a difficult financial situation.

Another country's law sets forth a two-stage procedure. In the first stage, when there is a marked reduction in capital, the central bank becomes involved and tries to find a buyer for the bank. The law is rather arbitrary on this point, as it requires that the acquiring bank must assume all of the liabilities and purchase all of the assets of the troubled bank. Experience has shown that this kind of sale is very difficult to accomplish, because troubled banks' credit files are sometimes in such bad condition that no prospective purchaser wants to acquire such questionable assets. From the point of view of insolvency law theory, to effect the sale of a bank—or the purchase of substantially all its assets and the assumption of all its liabilities—the receiver should be allowed to reduce the value of liabilities, provided that, in the receiver's opinion, no depositor or other creditor would receive less than would be received in a liquidation of the banks assets, which is the relevant alternative.

In the second stage of this law, if the bank declares—or the central bank determines—that it is insolvent, a court takes over and initiates bankruptcy proceedings. In these proceedings, a bankruptcy judge tries to settle the claims. If a settlement is not reached, the bank is sold free of certain liabilities, except deposits. The assets can then be sold piecemeal. This law, however, makes no mention of whether it is consistent with, or takes priority over, the existing bankruptcy law; also, it is inconsistent regarding the setting of priorities to distribute assets to satisfy the different classes of claims, and with respect to the role of creditors in reorganizing the bank. In general, a later law should supersede an inconsistent earlier law, but this is not always a clear rule of legislative interpretation and not the best way to determine the applicable law to manage a bank insolvency.

Chapter 22 The New Foreign Exchange Master Agreements

22A. The Significance of the International Foreign Exchange Master Agreement

JOHN P. EMERT

This chapter addresses how the new master netting agreements for foreign exchange can help to reduce systemic risk. It provides some information about the development of these master netting agreements and the variety of possibilities for their use, as well as a view of how the market is working to solve these problems. Market participants need to be able to net now and to have enforceable bilateral netting agreements in place as soon as possible. The subject of bilateral contracts between private participants in the markets will therefore be addressed in this chapter. The major agreement that will be focused on is the agreement for foreign exchange netting, called the International Foreign Exchange Master Agreement (IFEMA).[1]

The genesis of IFEMA was through the Foreign Exchange Committee, which is sponsored by the Federal Reserve Bank of New York but is independent of it, and the British Bankers' Association. In each jurisdiction, the agreements were developed by the private sector; however, the central banks and the banking supervisory agencies in each jurisdiction were advised of the developments in the private sector.

Characteristics of the Foreign Exchange Market

The foreign exchange market is a global, well-established market. In comparison with derivatives, foreign exchange transactions take place in many more centers. The foreign exchange market is also older; foreign exchange has existed practically since the beginning of time.

Yet, over the years, the characteristics of the foreign exchange market have changed. Foreign exchange, initially at least, was used as a medium of exchange for goods and, ultimately, investments. However, it can now also be used as a medium for speculation and the hedging of risks in one currency or another. Initially, many of the participants in the markets were banks, central banks, and parties that needed foreign exchange in connection with international trade. More recently, because of increased

interest in foreign exchange as a medium of investment, there are many new participants in these markets, including corporations and different types of pooled investment vehicles. Hedge funds are important players in the financial markets and have made large investments in various foreign currencies.

Documentation in the Foreign Exchange Market

Documentation practice in the foreign exchange market has evolved very rapidly in the past few years. In the past, because of the somewhat straightforward nature of foreign exchange as a medium of trade, people who transacted foreign exchange dealt in confirmations, which were often the sole piece of documentation for spot (current delivery) and short-dated forward transactions, particularly between dealers. Confirmations for these transactions show the parties to the transaction, the amount of currencies to be exchanged and the rate of exchange, the trade date, and the value (settlement) date. Confirmations also often contain delivery instructions. Because of the large volume of transactions entered into by foreign exchange dealers, the confirmation process is usually automated; although all parties include the same information in confirmations, as noted above, there is no standard format, except for messages sent over an electronic system, such as the Society for Worldwide Interbank Financial Telecommunication (SWIFT).

Netting Methods

In the beginning of the 1980s, market participants looking for ways in which to reduce settlement risk decided to apply portfolio management techniques. The concept of portfolio management emphasizes the portfolio of obligations that one counterparty owes to the other counterparty rather than the individual transactions. This concept was attractive to market participants, who were beginning to realize that parties active in the market would have a number of different transactions with each other, some of which would settle on the same date. Informal practices thus developed within the back offices (the operations systems of financial institutions) to settle these same-day payments on a net basis. At this point, the lawyers were not involved. The process was very simple: if one participant owed another a number of payments in U.S. dollars totaling, say, $5,000, and if the second participant owed the first a number of payments in deutsche mark totaling, say, DM 3,000, they would agree that the first participant would make only one payment, the net of all dollar payments, while the second would make one payment, the net of all deutsche mark payments.

Many participants employ netting methods to reduce risk. There are various methods of netting. First, in payments netting, payments between counterparties are netted so that only one payment in each currency is made for each value date. Second, in netting by novation, a new foreign exchange transaction entered into by counterparties for settlement on a particular value date is netted against any existing obligations to receive or deliver currencies for such value date; new obligations to receive or deliver the currencies involved are created by contract novation. Like payments netting, only one payment per currency is made by the parties on each value date. Before the adoption of the 1994 amendments to the Basle Capital Accord, netting by novation was the only form of netting recognized to reduce the capital exposure of banks.[2] A third method of netting is setoff. In foreign exchange options transactions, setting off one option against another, similar option terminates in whole or part the original option. Setting off foreign exchange options is analogous to the process of netting by novation foreign exchange transactions in the cash market. A final method of netting is close-out netting. Upon the occurrence of an event of default, the non-defaulting party has the right to close out all open transactions, convert them to the non-defaulting party's base currency, mark them to market, and net the resulting amounts, which will then become a payment owed either to or by the defaulting party. Limited two-way payments are not an accepted practice in the foreign exchange market.

Master Agreements

Market participants realized that it was necessary to deal with the problem of a counterparty defaulting on forward foreign exchange transactions. Because transactions settle on different value dates, the challenge was to apply what the traders do on a daily basis in managing their portfolios, namely, to attach a present value to a stream of payment obligations on a forward basis, even though those payments will be due in the future, so that there is one marked-to-market valuation due to or from one party or the other.

These concepts have become incorporated in documentation that is known in many types of trading as master agreements. They are master agreements because they represent a number of individual transactions that are all subsumed under one contract. Agreements for spot and forward foreign exchange transactions, as well as for foreign exchange options, generally follow the same structure. An agreement covering spot and forward foreign exchange transactions deals with the terms of the transactions, confirmations, netting by novation, and settlements. An agreement covering foreign exchange options deals with the terms of the

option, the payment of premium, confirmations, exercise of options, settlement, and setoff. Both spot and forward foreign exchange agreements and foreign exchange options agreements contain events of default that give the non-defaulting party the right to close out and net down open transactions.

Several foreign exchange master agreements have been established to date. In 1985, the Foreign Exchange Committee Foreign Exchange Netting and Close-Out Master Agreement was prepared. Another was the Worldwide Foreign Exchange Netting and Close-Out Agreement (the FXNET Agreement). FXNET is an automated trade comparison-and-matching system that facilitates the process of netting by novation. The FXNET Agreement also contains close-out provisions relating to foreign exchange transactions between counterparties in a local market. A FXNET Global Foreign Exchange Netting and Close-Out Agreement has been developed for parties that do not subscribe to the automated system. In 1992, the International Currency Options Market (ICOM) Master Agreement for Foreign Exchange Options was developed under the sponsorship of the Foreign Exchange Committee and the British Bankers' Association.[3] The ICOM Master Agreement reflects current market practice in the foreign exchange options market and provides a standard agreement for this market. In 1992, also, the International Swap Dealers Association (ISDA) Master Agreement was promulgated.[4] The ISDA Master Agreement can be used with ISDA foreign exchange definitions. Additionally, many participants amend their ISDA Master Agreement schedules to include specific foreign exchange market practice provisions, including netting by novation for spot and forward foreign exchange transactions, setoffs for foreign exchange options, and confirmation procedures. Finally, in 1993, the International Foreign Exchange Master Agreement (IFEMA) for spot and forward foreign exchange transactions came into being. IFEMA, which is the focus of this chapter, follows the general format of the 1985 Foreign Exchange Netting and Close-Out Master Agreement and reflects current market practice for spot and forward foreign exchange transactions.[5]

All these contracts state that the parties enter into the agreements with the intention of having only one contractual relationship, but with a number of different payments obligations. Moreover, the agreements make clear that this is the only reason that they enter into the relationship.

Legal Recognition and Enforceability of Netting Agreements

In the case of default by a party, the master agreement concept and the close-out provisions of foreign exchange agreements permit the

non-defaulting party to close out open positions without the risk of "cherry-picking" by a trustee or other representative of the defaulting party's estate. Cherry-picking is the practice followed by trustees in bankruptcy or other representatives of the estate of affirming those transactions that are of value to the bankrupt estate and disaffirming those transactions that are without value. If a master agreement is in effect, however, the non-defaulting party has a claim so that the trustee or representative of the bankrupt estate should recognize the portfolio of transactions.

In the United States, the Federal Deposit Insurance Corporation Improvement Act[6] provides that otherwise enforceable netting contracts between financial institutions (broker-dealers, depository institutions, future commision merchants, and other institutions, as determined by the Federal Reserve) are to be given effect notwithstanding any stay, injunction, or other order of any court or administrative agency.[7]

The Federal Reserve released in 1995 its Regulation EE under the netting contract provisions of the Federal Deposit Insurance Corporation Investment Act.[8] Regulation EE expands the definition of financial institution to satisfy both a qualitative and a quantitative test.[9] Under the qualitative test, the entity represents that it will engage in financial contracts as a counterparty on both sides of one or more financial markets.[10] Under the quantitative test, the entity must have possessed on any day during the previous 15-month period either (i) financial contracts of a gross dollar value of S1 billion in notional principal amount outstanding or (ii) total gross marked-to-market positions of at least S100 million in financial contracts with counterparties that are not affiliates.[11] The Federal Reserve has stated that the test can apply to both U.S. and non-U.S. entities. The term "financial contract" includes foreign exchange spot, forward, and options contracts, as well as swaps, repurchase contracts, securities contracts, and the like.[12]

Initially, as noted above, only netting by novation qualified for reduction of exposure for bank capital adequacy purposes.[13] The Basle Committee on Banking Supervision then amended the Basle Capital Accord so that netting, including close-out netting, is now recognized for capital adequacy purposes, subject to three considerations.[14] First, the netting agreement must create a single, enforceable obligation, so that, upon the happening of an event of default, including an event of default resulting from the insolvency of the counterparty, a non-defaulting party can close out and liquidate open positions, resulting in one payment made by one party to the other party. Second, the bank must have written, reasoned legal opinions as to the enforceability of the netting agreement in all jurisdictions that have a connection to the transac-

tions under the agreement. Third, the bank must have a process in place to ensure that legal issues involving netting are kept under review to keep up with changes in the law.

In the United States, the Federal Reserve has amended its risk-based capital guidelines to recognize the risk-reducing benefits of netting agreements[15] and to implement the recommendations of the proposal of the Basle Committee on Banking Supervision addressed above. The Federal Reserve requires that the banking organization have the written, reasoned legal opinions described above, which conclude to a "high degree of certainty that the netting contract will survive a legal challenge in any applicable jurisdiction."[16] The opinions may be prepared either by an outside law firm or by in-house counsel. The netting agreement and opinion (and translations into English, if necessary) have to be available for inspection by the Federal Reserve.[17] The Federal Reserve has the discretion to disqualify contracts from netting treatment if the contracts or legal opinions do not meet the requirements set out in the guidelines.[18]

Multibranch Issues

In multibranch situations, a banking firm will need to have opinions in the country of jurisdiction of the two counterparties, as well as opinions in all jurisdictions in which the banking firms are doing business through branches. Essentially, three-dimensional opinions will be needed. A two-dimensional opinion says that netting is enforceable under the laws of that jurisdiction, while a three-dimensional opinion says that netting is enforceable not only under the laws of that jurisdiction but also across jurisdictions. In the event of the insolvency of a branch, there is no impediment to claiming a net amount at the head office level if a three-dimensional opinion has been received.

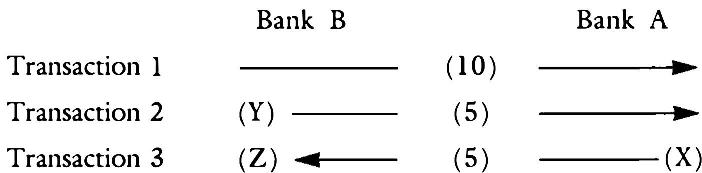
The issue of master agreements involving parties that trade in multiple jurisdictions might thus be called the multibranch question. Many participants, particularly banks, make foreign exchange transactions from both their head offices and their branches worldwide. In order to satisfy the Basle Capital Accord standards for the recognition of close-out netting, a bank is required to obtain legal opinions that the master agreement is enforceable in bankruptcy under the laws of the jurisdiction whose law governs the agreement, the jurisdictions where the head offices of the parties are located, and the jurisdictions where branches subject to the agreement are located. For banks headquartered in the United States, it is likely that, for an agreement subject to U.S. law, a U.S. court would recognize a provision netting the outstanding transactions of

the head office and branches; this is a question that needs to be asked of counsel in each jurisdiction covered by a multibranch agreement. Many jurisdictions recognize netting at the head office level. In other jurisdictions, the law of that jurisdiction may require that the non-defaulting party pay the defaulting party's branch for transactions involving the branch where the branch was owed money.

In these circumstances, participants may respond in a number of ways. They may opt to (i) transact only in jurisdictions where there is legal certainty that the netting agreement is enforceable in bankruptcy; (ii) enter into separate agreements for each jurisdiction or pair of branches; or (iii) use a severability clause in the master agreement that would permit netting across pairs of branches only if the non-defaulting party determined that the netting was legally enforceable.

For example, bank A and bank B may sign an IFEMA that lists as designated offices the head office of each bank, which is in jurisdiction X, (for example, the United States). Bank B will also trade out of branches in jurisdiction Y and jurisdiction Z. Bank A will trade only in the United States, jurisdiction X. Suppose that three foreign exchange transactions are outstanding, as shown in Figure 1.

Figure 1



In the first transaction, on a marked-to-market basis (meaning that present value is applied), bank B owes bank A 10 units of currency, as of today. In the second transaction, bank B's office in jurisdiction Y owes bank A 5 currency units. In the third transaction, between bank A in jurisdiction X and the branch of bank B in jurisdiction Z, bank A owes bank B 5 currency units. So, from bank A's standpoint, for the three transactions on a marked-to-market basis, bank B owes bank A 10 currency units, for a total of 15, while bank A owes bank B 5 currency units. If the netting agreement were totally effective in all jurisdictions, bank B should owe a net amount of 10 currency units to bank A.

However, it is not known exactly whether the above example could actually happen. The Bank of Credit and Commerce International (BCCI) is an important example of a financial institution that was dealing in many jurisdictions and became insolvent. If on a net basis, bank A

has 10 currency units of assets of bank B and wants to set those off against the amounts that bank B owes it, bank A should be concerned that, because of the bankruptcy regime in jurisdiction Z, it may have to pay bank B for those transactions that are booked in the branch without receiving payment for the other transactions owed it by bank B.

The problem is the uncertainty about whether the bankruptcy regime in each country will be the same. The BCCI case showed that there are two different types of bankruptcy regimes, the local and the universal. Under the local bankruptcy regime, the branch of the foreign bank can be liquidated as though it were a separate entity. Therefore, the representative in jurisdiction Z of the branch of bank B would treat this obligation from bank A as a separate obligation, which could not be netted at the head office level. Other jurisdictions follow a universal approach, under which the representatives of the bankrupt estate in jurisdiction Y would assemble assets and liabilities and, ultimately, turn them over to the liquidator in the head office's jurisdiction of country X. As a result, legal counsel and banking organizations need to ask to what extent bankruptcy issues on a three-dimensional basis can affect the calculation of the ultimate amounts payable under netting agreements.

Financial Intermediaries

A second issue involves dealing with financial intermediaries. A participant in the foreign exchange market should analyze carefully the identity of its counterparty. It is a principle of common law that an agent acting on behalf of an undisclosed principal is a party to the transaction.[19] In addition, "[u]nless otherwise agreed, a person purporting to make a contract with another for a partially disclosed principal is also a party to the contract."[20] A participant dealing with an intermediary should require the intermediary to identify its principal. The participant should do due diligence on the creditworthiness of the principal and on the authority of the principal to enter into transactions and to delegate this authority to the intermediary. The intermediary should provide promptly an allocation of transactions by principal if the transaction is done as a block trade. For example, suppose bank A is dealing with a hedge fund. The hedge fund is represented by party X, an agent to the hedge fund. In order to know exactly who is a credit risk, bank A will have to do an analysis on two levels. First, it will have to determine whether the hedge fund is properly incorporated and has the power to contract to buy and sell foreign exchange. There may be an issue of ***ultra vires*** if the hedge fund is not authorized to contract for foreign exchange transactions. Second, party X is the intermediary; in this example, bank A never directly transacts with the hedge fund, but with its intermediary, party X. Therefore,

in addition to checking the power of the hedge fund, bank A must also check the delegation of authority by the hedge fund to party X enabling it to deal with bank A.

In the market, if one does not know the identity of the counterparty, one does not sufficiently understand the risks involved in dealing with an agent in foreign exchange or any type of traded product.

22B. An Analysis of the International Foreign Exchange Master Agreement

RUTH AINSLIE

This chapter deals specifically with the provisions of the International Foreign Exchange Master Agreement (IFEMA),[1] which was published in the United States in November 1993 and in the United Kingdom in December 1993.[2] The major issue is the extent to which enforceable global master agreements should protect against systemic risk by allowing counterparty failure to be handled on the basis of a net, rather than a gross, valuation of the deals under the agreement.

There are currently three forms of master agreements accepted as industry-standard documentation governing bilateral trading in the interdealer spot and forward foreign exchange markets. First, the 1992 International Swap Dealers Association (ISDA) Master Agreement[3] can be used as a cross product master agreement covering not only swaps (where it was traditionally the standard document) but also a variety of other products, including foreign exchange and currency options. Second, the FXNET Worldwide Netting and Close-Out Agreement,[4] published in 1993, covers only foreign exchange trades and has not come into very wide use. IFEMA[5] has been gaining wider acceptance globally as a product-specific foreign exchange master agreement. It was drafted to reflect the current market practices in the interdealer spot and forward foreign exchange markets. IFEMA incorporates into the master agreement, as do both of the other agreements, appropriate legal rights and obligations. It is slightly different from the ISDA Master Agreement, which contains primarily credit-based provisions (unlike the more product-specific and market-practice-sensitive IFEMA). In order to reflect market practices, one can add the product-specific terms to the schedule to the ISDA Master Agreement.

Each of these agreements functions in a similar way. Each includes market practice provisions to a greater or lesser extent, events of default, and a method of liquidating outstanding transactions after a default. These agreements are organized slightly differently, but they contain many of the same provisions. Moreover, perhaps most significant to those who are unfamiliar with these agreements, the ISDA Master Agreement and IFEMA both have reader-friendly guides that explore in detail the purpose of specific provisions and, sometimes more important, explain why specific provisions have been omitted. The guide to IFEMA is helpful in fleshing out details of that agreement.

Section 1: Definitions

The definition section comes first in IFEMA. These definitions have become accepted as industry standard and generally conform to those in the ISDA Master Agreement. This was a deliberate attempt to ensure that, when one institution deals with another institution in more than one master agreement, the same set of credit protections should apply across those master agreements.

Clearly, the most significant of the definitions is that of an "event of default."[6] Events of default apply either to failures under the terms of IFEMA, which would primarily involve payments, or to occurrences related to the creditworthiness of a party. Because these events of default are specific to the counterparties, some parties have desired to include in the definition affiliates of the counterparty, in order to assess more accurately the credit standing of an institution in its broadest sense. The practice of including affiliates is quite typical in the swap markets under the ISDA Master Agreement.

Examples of defaults related to creditworthiness that prove to be early-warning triggers of the deterioration of a counterparty would be cross default to specified indebtedness and cross default to specified transactions. Cross default to specified indebtedness occurs if a party to the IFEMA defaults on debt for money borrowed to any third party in excess of a threshold amount (which should be a standard of materiality). If such default occurs, the other party to the IFEMA has the right to close out all of the transactions under the IFEMA.

A different, but equally good, standard of credit standing is cross default to specified transactions. In this provision, a default under another master agreement or under another agreement with a counterparty in another type of trading transaction, in any amount, would permit the party to close out all defaults under the IFEMA if, under the other agreement, action has been taken with respect to that default. These cross default provisions are becoming standard in virtually all of the master agreements. The provisions are aimed at protecting one counterparty against its counterparty and should be much more helpful in dealing with systemic risk issues because they capture whole entities.

In addition, the parties may agree to include on the schedule as an event of default the right of one party that has "reasonable grounds for insecurity" to require "adequate assurances"[7] from the other party of its ability to perform its obligations under the IFEMA. Failure to deliver such adequate assurances after two business days constitutes a default. Because of the subjective nature of this provision, which could be trig-

gered by an unfounded rumor, an article in a newspaper, or more substantiated reasons, many counterparties are increasingly reluctant to include this provision in agreements. The British Bankers' Association, in fact, has stated publicly its lack of support for rights in the nature of adequate assurances. This position is indicative of the clear movement in the market toward using objective standards for events of default in these kinds of transactions.

Section 2: Structure of IFEMA

Scope

The agreement then describes the structure of transactions under it. The agreement governs all foreign exchange transactions entered into after the date of the IFEMA between each counterparty's trading branches that have been so designated on the schedule to the agreement. Consequently, a foreign exchange transaction under the agreement is a transaction entered into by one party or its designated offices and the other party through its designated offices. It is the trading through these designated offices, which are branches located presumably anywhere in the world, that gives rise to some of the multibranch issues arising under IFEMA. The agreement also allows the parties to incorporate all transactions outstanding prior to signing the agreement.

Single Agreement

The IFEMA is a master agreement, incorporating the agreement itself, as well as all confirmations, schedules, and annexes. It is intended to be a single agreement and therefore immune to cherry-picking, a practice according to which a trustee in bankruptcy may pick and choose among transactions of the bankrupt estate, assigning validity to some and rejecting others.

Confirmations

Foreign exchange transactions are expected to be confirmed in writing immediately after being entered into by the participants. The product is a simple product and has remained virtually unchanged over time. The confirmations continue to contain only the economic terms of a transaction. Increasingly, confirmations are sent electronically. The Federal Reserve Bank in New York,[8] as well as the London Code of Conduct,[9] has stated that it is best market practice to confirm in writing all transactions.

In Section 8.15 of the miscellaneous section, IFEMA discusses confirmation procedures. It states that, in the event of an inconsistency between the terms of the IFEMA and any confirmation, the master agreement shall control. In other markets, including currency options and derivatives products, the confirmation prevails over any inconsistency with the master agreement. This difference in market practices between the foreign exchange market and the market for currency options and derivatives partly reflects the well-established practice in the foreign exchange market, but it probably has more to do with the simplicity of the trades and the lack of information contained in confirmations for foreign exchange transactions other than purely economic terms. It is best market practice to confirm in writing all transactions, including spot trades.

Section 3: Settlement and Netting

Section 3 of IFEMA deals specifically with settlement, that is, the delivery of currencies on a value date, and netting. Section 3 deals with netting to reduce settlement risk: payments netting and novation netting. Both these types of netting are employed in predefault situations. Payments netting simply serves to reduce the amount of payments that go from one party to another. Novation netting legally extinguishes a trade as of the trade date while reducing the obligation to be paid subsequently.

Both payments netting and novation netting require the development of systems and operations. However, most of the parties signing the agreement have chosen to opt out of settlement netting and novation netting provisions because of operational constraints. As a result, the IFEMA is used primarily as a close-out agreement. However, the massive reduction in settlement risk possible through netting should encourage participants to develop systems or rely on counterparties' systems, so that these types of netting become more interesting to both counterparties.

Section 4: Representations, Warranties, and Covenants

Section 4 is the representation section. In it, IFEMA requires that each party represent that it is authorized to enter into and to perform the agreement. It also asks that each party represent that it is acting as a principal. Representations can provide comfort but they cannot assure authority or suitability. For example, a transaction that is later deemed to be ***ultra vires*** (that is, beyond the authority of a counterparty) is not an authorized trade and accordingly will not be enforceable. This is what occurred in the swap context in the ***Hazell v. Hammersmith and Fulham***

London Borough Council case.[10] Representations are reconfirmed on each trade date. Frequently, an institution may look to a legal opinion to give greater comfort on these issues.

Section 5: Close-Out and Liquidation

The next section, dealing with close-out and liquidation, is the heart of IFEMA. The ability to close out all transactions and determine a single net payment owing from one party to the other clearly reflects the "single agreement" nature of IFEMA. It is the conclusion that the close-out provision is enforceable under applicable law that will support the recognition by qualifying institutions of the benefits of netting in reducing the amount of capital required and permit credit officers to view credit exposure on a net basis under IFEMA.

Methodology

Foreign exchange transactions are closed out by determining the replacement cost of all outstanding transactions and calculating a single net payment to be made by one party to the other.

Loss Versus Market Quotation

Market practice among foreign exchange dealers is that the non-defaulting party determines the close-out amount. The non-defaulting party must demonstrate good faith and commercial reasonableness. IFEMA reflects the difference in market practice between foreign exchange, on the one hand, and derivatives, on the other hand. Prices are easy to obtain in the liquid cash market. In addition, in contrast to some derivatives, the tenure of trades is usually not very long. Derivatives, however, are highly complex and difficult to price because the markets are not as liquid and the transactions are highly structured. In most swap agreements, external sources are used for market quotations to determine the value. In the interdealer market in foreign exchange, however, each dealer has access to those values.

Enforceability in Insolvency

A major issue is the enforceability in insolvency of the netting of all outstanding transactions under the close-out agreement. There is little doubt, except in situations of insolvency, that most of these agreements are enforceable as contracts between two parties governed by the law agreed by the parties. In the event of an insolvency, enforceability of net-

ting provisions is determined on a country-by-country basis. In order to comply with the Basle Committee on Banking Supervision's guidelines,[11] robust legal opinions are required as to the enforceability in insolvency of the close-out provisions of the IFEMA in each jurisdiction where a counterparty is incorporated, or where one of its branches is transacting under the IFEMA. Industry groups, including the ISDA and the group that has prepared the IFEMA, are in the process of obtaining agreement-specific legal opinions on insolvency in a variety of jurisdictions.

Other Transactions

IFEMA provides that on its close-out the non-defaulting party has the explicit right to include other foreign exchange transactions with its counterparty that were entered into through branches not included as designated offices. This provision is designed to achieve greater credit protection with respect to a single counterparty. In addition, as a savings clause, IFEMA specifically states that the non-defaulting party is permitted to exclude the closing-out of certain transactions when, in its good-faith judgment, close-out of such transactions may not be enforceable under the laws applicable to the jurisdictions covering those transactions. As in most other master agreements, if an event of default has occurred and no action has been taken to close out, or if an event of default is pending, the counterparty has the right to suspend performance, depending on the passage of time or the giving of notice. In addition, all other legal rights that would be available to a counterparty, such as common law or statutory rights of setoff, will be available in the event of a close-out.

Section 6: Force Majeure

A separate section, force majeure, has been included to deal with failures beyond the control of a counterparty. Examples include the counterparty's inability to pay, or the prohibition of its making any payments under the IFEMA, owing to act of state, illegality, impossibility, or force majeure. This situation occurs with some frequency in foreign exchange markets, largely because of the volume of payments made daily in multiple jurisdictions around the world. When such an event occurs, only the affected transactions may be closed out; there is no right to close out all transactions.

Section 7: Expertise

Section 7 stipulates that the parties are to rely on their own expertise. They are dealing as principals and should not rely on each other's advice in dealing with trades.

Section 8: Miscellaneous

The miscellaneous section has many "boilerplate" provisions. The two most important are probably the currency indemnity and tape recording provisions.

Currency Indemnity

The currency indemnity provision requires that payments made after default or force majeure, or because of a judgment of a court, should be made in the "base currency" of the receiving party. This base currency is typically the home currency, U.S. dollars, or pounds sterling.

Tape Recording

Tape recordings are an important part of the foreign exchange market. It has been deemed in the United States and the United Kingdom that it is best market practice to record conversations between dealers. The conversation (whether oral or electronic) between dealers is the binding contract; a written foreign exchange confirmation is supplementary evidence of that transaction. These recordings can be submitted to a court of law as evidence and should overrule a confirmation later produced by a back office.

Section 9: Law and Jurisdiction

IFEMA provides for New York or English governing law. Japanese law, Canadian law, Australian law, and Hong Kong law versions of IFEMA have also been published or are in the process of being published.

Section 10: Schedule

The schedule is the part of the agreement between the counterparties that can be tailored to include specific provisions. It is where the parties specify their designated offices and payment instructions, and where they elect to include certain provisions, such as adequate assurances. Usually, it is best to include as designated offices any branches through which the parties may intend to enter into transactions, although the inclusion of branches in countries that do not have clear legislation with respect to netting can leave the enforceability of the agreement open to interpretation or uncertainty.

Currency Options Master Agreement

Currency options have their own specific agreement as well, the International Currency Options Market (ICOM) Master Agreement,[12] which was published in 1992. A restated ICOM Master Agreement was published in May 1993, revised to conform to the more recent IFEMA as to market practices and credit protections.[13] Any of the product-specific master agreements can be combined with other product-specific master agreements by the use of a "master" master agreement, which comes in many forms under U.S. laws and would be enforceable under English and New York law. Each of these special agreements would, after a default, allow netting across the net amounts from each of the master agreements. Research has not yet been done to determine whether these master agreements are equally effective in other countries, but there may be a way to achieve cross product netting of foreign exchange trades with other trades. Additionally, a combined version of the ICOM Master Agreement and IFEMA, for use with both currency options and spot and forward transactions, called the Foreign Exchange and Options Master Agreement (FEOMA), was prepared for publication in 1996. Currency options are frequently documented under the ISDA Master Agreement, which was designed as a cross product master agreement. Frequently, an ISDA Master Agreement is modified to add certain of the currency options market practice provisions when it is used for currency options. In any event, however, an ISDA Master Agreement covering currency options should be equally as enforceable as the ICOM Master Agreement.

COMMENT

RAJ BHALA

This comment is divided into three parts: review, analysis, and issue spotting. First, the salient features of the prior chapters on the new master foreign exchange trading agreements are briefly summarized. Second, the critical issue, cherry-picking, is analyzed. Third, a few difficult and unresolved problems concerning the International Foreign Exchange Master Agreement (IFEMA)[1] are identified.

The Foreign Exchange Market and IFEMA

The foreign exchange market is vast. IFEMA is important because the market that it pertains to is so important. The average daily turnover in the market for spot and forward foreign exchange contracts is approximately $1 trillion—the largest financial market in the world. The market is global, and trading occurs virtually around the clock. It is a market that defies national borders and, therefore, local contract law. IFEMA is the world's first standard-form contract designed expressly for this unique market.

Until IFEMA was introduced in 1993, there were few standard-form agreements available to govern the rights and obligations of parties to spot and forward transactions. The FXNET Worldwide Netting and Close-Out Agreement[2] was not adopted on a widespread basis. Few market participants modified the International Swap Dealers Association (ISDA) Master Agreement[3] to cover their spot and forward transactions. This contractual void created uncertainty among participants. To be sure, there were well-developed customs and practices. However, formal legal documentation with supporting legal opinions obviously provides greater comfort to commercial and investment banks that actively trade in the foreign exchange markets—and to the regulatory authorities that supervise these institutions and markets.

The importance of IFEMA is underscored by the enormous risks associated with foreign exchange trading. For example, there is credit risk, the risk that a counterparty will fail to settle its position (that is, fail to deliver the currency that it is obligated to deliver) because of liquidity problems or outright insolvency. There is also "Herstatt risk," the risk that a party whose office is in one time zone may fulfill its obligation to deliver cur-

rency but not receive the currency that it is owed from a counterparty whose office is located in a different time zone. This risk also can result from liquidity problems or insolvency of the counterparty. Finally, systemic risk is the risk that a default or failure by one party may have knock-on effects, causing other parties to default or fail. The default may concern an obligation owed under a foreign exchange contract, and the knock-on effects may concern the foreign exchange market. The driving force behind IFEMA is the attempt to minimize at least some of the risks associated with foreign exchange trading by implementing contractual protections for the parties.

More specifically, IFEMA accomplishes (or attempts to accomplish) six goals. First, IFEMA establishes with certainty and precision the contractual rights and obligations of the parties to a spot or forward transaction. Second, it governs all foreign exchange spot and forward transactions between the designated offices (that is, the head office and branches) of the parties. Third, IFEMA minimizes the likelihood of cherry-picking should credit risk or Herstatt risk materialize and the counterparty fail to deliver foreign exchange. Fourth, because it is a written agreement, IFEMA should help resolve the problem of enforceability under the statute of frauds. Fifth, IFEMA is a single, integrated agreement and, therefore, should help avoid problems arising under the "parol evidence" rule regarding the inadmissibility of prior or contemporaneous inconsistent statements, whether oral or written. Sixth, IFEMA clarifies that it, and not any written confirmations of a foreign exchange transaction, establishes the terms of a transaction in the event of an inconsistency between the IFEMA and confirmations. At the same time, IFEMA also states that a tape recording of the transaction negotiated by foreign exchange traders is the best evidence of those terms.

Analysis of IFEMA

The heart of IFEMA is the provision on close-out and liquidation netting.[4] It is designed to address the problem of cherry-picking. How it does so is worth examining. Suppose that two banks, Citibank and Bankers Trust, trade dollars and yen in the spot market on Wednesday, May 18 for value on Friday, May 20. Suppose that there are three such transactions (see Figure 1). In the first deal, Citibank owes Bankers Trust $100,000. In the second deal, Citibank owes Bankers Trust $50,000. In the third deal, Bankers Trust owes Citibank $60,000. Without netting, three separate payments must be made—two from Citibank to Bankers Trust of $100,000 and $50,000, respectively, and one from Bankers Trust to Citibank in the amount of $60,000.

Figure 1

	Citibank		Bankers Trust
Transaction 1	————	(S100,000)	————►
Transaction 2	————	($50,000)	————►
Transaction 3	◄————	($60,000)	————

IFEMA expressly calls for payments netting in this situation. Therefore, only one payment of $90,000 from Citibank to Bankers Trust must be made, resulting from the sum that Citibank owes to Bankers Trust ($150,000) less the amount that Bankers Trust owes Citibank ($60,000). Payments netting, however, is conceptually and operationally distinct from close-out and liquidation netting. Payments netting is designed to occur as a routine matter and presupposes that neither party is unable to settle its payment obligations. When a party defaults on an obligation—or, more generally, when any event of default specified in IFEMA occurs—liquidation and close-out netting is triggered.

Suppose that Citibank defaults on either a specified indebtedness to a third party (such as the Bank of Tokyo) or on a specified transaction with Bankers Trust not governed by the IFEMA. Each of these occurrences is an event of default under IFEMA. Accordingly, Bankers Trust is entitled to close out all of its outstanding transactions with Citibank. Suppose further that the reason for Citibank's default is that it has become insolvent.

Here is the scenario that Bankers Trust fears: the Federal Deposit Insurance Corporation (FDIC), having been appointed the receiver for Citibank by the Office of the Comptroller of the Currency, cherry-picks among the three spot deals. If it could lawfully do so, the FDIC would reject the $100,000 and $50,000 transactions because these involve payments out of the debtor's (Citibank's) estate. If these payments were to be made, the pool of funds available for depositors and other unsecured creditors that the FDIC must protect would be diminished. However, the FDIC would seek to assume the $60,000 deal because this involves a payment into the estate, thereby enhancing the asset pool.

If the FDIC were allowed to cherry-pick, Bankers Trust would have to pay $60,000 to Citibank's receiver and stand in line as a creditor of Citibank. In this position, Bankers Trust would receive the proverbial "ten cents on the dollar," or $10,000. Thus, Bankers Trust's net loss would be $50,000 ($60,000 less $10,000). Yet, it had expected $90,000 from the three dollar-yen spot deals!

The liquidation and close-out netting provision of IFEMA would help Bankers Trust avoid this unsatisfactory scenario. Bankers Trust would be

authorized to activate the close-out and liquidation procedure upon an event of default. As the non-defaulting party, Bankers Trust would, in good faith and subject to reasonable commercial standards, determine the close-out amounts corresponding to each of the three spot transactions. This calculation is based on a formula set forth in IFEMA. It yields a replacement cost for the transactions and a single, net lump-sum payment amount. This amount must be paid by whichever party is the payment obligor. In this example, Bankers Trust would close out all three spot dollar-yen transactions, convert them to a base currency (in this instance, U.S. dollars), mark the transaction to market, and net the resulting amounts to yield one payment obligation. If the values used above were the relevant costs calculated under the contractual formula, a single payment of $90,000 would be made by Citibank to Bankers Trust.

Could the FDIC, as receiver for Citibank, block the operation of IFEMA's close-out and liquidation procedure, reinstate the gross obligations, and cherry-pick among the three dollar-yen spot deals? No, not under U.S. law. The Federal Deposit Insurance Corporation Improvement Act of 1991[5] and Federal Reserve Regulation EE[6] assure the enforceability of the IFEMA netting provision. However, the hard case occurs when Bankers Trust's defaulting counterparty is a bank's designated office subject not to the laws of the United States but rather to those, for example, of Germany, Morocco, Malaysia, or Uruguay. To what extent is the IFEMA close-out and liquidation procedure legally enforceable under the insolvency laws of such other jurisdictions? Naturally, the answer depends on the law of the foreign jurisdiction. Based on legal opinions obtained by the Foreign Exchange Committee (the organization that sponsored the IFEMA drafting project), the procedure is likely to withstand cherry-picking efforts in the United Kingdom and Japan, just as in the United States. It is not surprising that the Basle Committee on Banking Supervision's capital adequacy guidelines require legal opinions as to the enforceability of the IFEMA close-out and liquidation netting provision for each jurisdiction in which a designated office or a party to IFEMA is located.[7] Without such opinions, favorable treatment under the risk-based capital guidelines is unavailable (namely, a capital charge is imposed on gross rather than net exposures arising from foreign exchange transactions).

Issues Regarding IFEMA

The extraterritorial enforceability of the liquidation and close-out netting provision is only one example of an unresolved issue arising under IFEMA. A number of others are readily apparent. First, why should market participants sign the IFEMA? In particular, what incentives do banks

located outside the major trading centers of New York, London, and Tokyo have to enter into the agreement? This question also applies to the International Currency Options Market (ICOM) Master Agreement.[8]

Second, to what extent are different master agreements competing products? Is the market better served by a single standard-form contract?

Third, given that the heart of IFEMA is the close-out and liquidation netting provision, is it reasonable to conclude that IFEMA is an unbalanced agreement that is drafted largely from the position of the non-defaulting party? More specifically, is the close-out and liquidation netting provision of IFEMA a bankruptcy preference granted to the non-defaulting party in a foreign exchange contract at the expense of unsecured creditors of the defaulting counterparty? After all, by preventing a receiver like the FDIC from cherry-picking, the size of the asset pool available to other creditors to satisfy their claims is diminished.

Fourth, do the events of default specified in IFEMA actually increase systemic risk? These events are broadly drafted. Some of them are subjective standards. For instance, the demand for "adequate assurances," which could be triggered by a rumor in the market or a newspaper, could cause an otherwise healthy counterparty to experience difficulties in settling its payment obligations. In turn, other parties with exposures to (that is, owed money by) the counterparty could be adversely affected.

Fifth, suppose that a bank has several different branches that are actively involved in foreign exchange trading. Can the obligations of the branches be netted? That is, is multibranch netting possible under IFEMA? If so, the Basle Committee on Banking Supervision would presumably require a legal opinion regarding the enforceability of the liquidation and close-out netting provision from each jurisdiction in which a branch is located. As a practical matter, what is the likelihood of obtaining such opinions, particularly in the case of a bank like Citibank, with branches in dozens of countries?

Sixth, a cross product master agreement is a single, integrated agreement that covers several different foreign exchange instruments (for example, spots, forwards, options, and swaps). While the ISDA Master Agreement can serve as a cross product contract, it has not been widely used as such. IFEMA does not purport to be a cross product master agreement. What are the prospects for devising such an agreement that would gain widespread use? Would that agreement, from the perspective of bank regulators and market participants, reduce systemic risk? Or would that agreement exacerbate the financial difficulties of counterparties—and thereby perhaps increase the possibility of systemic risk because it calls for universal close-out and termination upon an event of default?

Finally, what role, if any, should bank regulators and the Basle Committee on Banking Supervision play in developing future master agreements for specific financial transactions? Currently, the Foreign Exchange Committee is sponsoring work on an agreement that would govern gold bullion trading. The Committee acts under the auspices of the Federal Reserve Bank of New York. Should the Federal Reserve play a more active and visible role, or should it remain entirely on the sidelines?

Some of these questions may be debated for years to come. Nonetheless, it is clear that the advent of IFEMA represents a new, more legalistic phase in the growth and the development of the world's largest financial market.

Chapter

23 Financial Derivatives

23A. Over-the-Counter Derivatives

DANIEL P. CUNNINGHAM

If one has been following the financial news in the United States recently, one could well have the impression that a specter is haunting the world's financial markets: over-the-counter derivatives activity, also known in shorthand as OTC derivatives. In future years, people will look back on the current concerns and come to the conclusion that the markets were to a great extent afraid of the complex and unknown. This chapter analyzes what OTC derivatives are, their uses, and a technique for managing credit risk for OTC derivatives known as netting.

Defining OTC Derivatives Transactions

The label "OTC derivatives" encompasses a wide variety of instruments. In essence, an OTC derivative is a nonstandardized financial instrument that does not trade through any particular exchange or clearinghouse; hence, the name "over the counter." Because they are not standardized, OTC derivatives can be customized to fit the particular needs of the "consumer" of the OTC derivative. This consumer is often called an end user. The interests of end users of OTC derivatives are represented by The End-Users of Derivatives Association. OTC derivatives are often tailored to satisfy the very specific demands of end users.

End users enter into OTC derivatives for a variety of reasons. The standard use for an OTC derivative is "hedging." One of the simplest OTC derivatives products is a "currency swap." A currency swap is a simple exchange of cash flows between a dealer of OTC derivatives and an end user. If an end user is expecting to receive future payments in another currency, a currency swap will "hedge" the end user against changes in that currency, thereby eliminating the currency risk. For this type of end user, a decision not to hedge can be a form of speculation.[1] Basic swaps can also be used to hedge interest rate risk. In this instance, an end user that has obligations attached to a floating interest rate, such as the London interbank offered rate, can exchange them for a more predictable flow—a fixed rate.

These examples of hedging through swap transactions constitute some of the most basic hedges that are created with OTC derivatives. More complex risk management is also possible. For example, equity derivatives can be used to hedge certain equity risks. If an entity holds a block of stock and wants to avoid the volatility inherent in the stock without selling it, the return on the stock can be swapped for a series of fixed cash flows. In this way, an end user can in essence cash out the present value of the expected returns on an equity while avoiding a sale of stock, which might have unwanted tax or securities law consequences or might be restricted otherwise

The demand for OTC derivatives has steadily grown. However, the size of the market is hard to measure. One possible measure is simply notional amount. Notional amount, however, grossly overstates the true credit risk generated by OTC derivatives activity and the true economic impact of the transactions. The notional principal amount outstanding of swaps increased from $867 billion in 1987 to $3,872 billion in 1991.[2] In fact, the replacement costs—the market values of derivatives transactions—for all OTC derivatives tend to be about 2–3 percent of the gross notional amount.

An illustration of the changing market value of a derivatives transaction is helpful. At the start of a basic interest rate swap, the replacement cost (the market value) will be zero because, by definition, each of the cash flows being "swapped" is worth the same amount at the start of the transaction. The market price of the floating rate, therefore, equals the market price for the fixed rate. However, interest rates will change over time, and the floating rate that would be swapped for an equivalent fixed rate will change. As a result, the original contract will become valuable to one party, the party "in the money"; the contract will become a liability for the other party, the party "out of the money." The present value of the amount that these parties are in or out of the money will be the market value of the swap. When people speak of "marking to market," they are referring to the calculation of this number, which also represents the credit risk, or replacement cost, for the in-the-money party.

Benefits and Risks of OTC Derivatives Transactions

The size of the market suggests that a large number of end users find significant benefits from OTC derivatives transactions. Why is this so? What utility is created by this market? Empirically, the size of the market would seem to speak for itself. Analytically, a number of explanations have been advanced concerning the utility of OTC derivatives. Some explanations point to an increased volatility in interest and exchange rates over

the past two decades. Observers suggest that events such as the collapse of the Bretton Woods system of fixed parities and the inflation of the late 1970s have created large costs for multinational firms through increased volatility. It is possible, therefore, that OTC derivatives are valuable because they ameliorate these significant costs.

Most regulators and observers appear to approve of hedging. After all, the word "hedging" has a nice, safe ring to it. However, certain uses for OTC derivatives, although believed by some observers to be good and to add value, are seen by other observers as the dark side of derivatives activity. For example, OTC derivatives allow speculation on a particular currency or interest rate at relatively low transactions costs. It is thus cheaper to enter into a swap with cash flows tied to the return of the Standard & Poor's 500 Index than it is to actually buy 500 different equities. On balance, it appears that lower transactions costs for certain forms of investment are a net good to society. It is undeniable that lower transactions costs make it cheaper to speculate, but they also make it cheaper to hedge and cheaper to invest.

Leverage is another issue that has concerned some observers. Customized derivatives can be used to achieve high levels of leverage—the perils and benefits of which have been known for some time. If someone is willing to extend the credit—at a price, of course—there appears to be no harm as a general matter in allowing an entity to utilize that credit through an OTC derivatives transaction. After all, credit and leverage are essential parts of market capitalism. Of course, as the Group of Thirty report on derivatives recommended, it is important that management understand the risks that it is taking.[3] As some well-known companies in the United States have recently discovered—or claim to have recently discovered—an OTC derivatives transaction can be a highly leveraged proposition. Every end user needs to formulate clear policies on the appropriate use of derivatives. Bad policies can always be avoided; violations of policy, however, are more difficult to avoid.

Another concern of certain regulators and observers is credit risk. If a party to an OTC derivatives transaction that is out of the money falls into insolvency, the other party will lose the economic value of the transaction. Some fear that, if a money center bank were depending on a counterparty that fell into insolvency, a "domino effect" could result, with one default triggering other defaults in a cascading fashion.[4]

There are things that can be done, however, to reduce credit risk. One method is netting. The basic question is whether exposures between two counterparties to a bilateral derivatives transaction master agreement should be netted against each other. If an OTC derivatives dealer has entered into a single transaction with an end user, the dealer's credit risk

in the event of the insolvency of the end user is easy to understand. However, if the dealer has entered into a series of derivatives transactions with another party (documented, one hopes, under a single master agreement, such as the 1992 International Swaps and Derivatives Association (ISDA) Master Agreement), the dealer's credit risk is more complex. Upon bankruptcy, three things could happen to the group of derivatives transactions: (i) they all could be continued; (ii) they all could be terminated; or (iii) the derivatives transactions favorable to the insolvent party could be continued while the rest are terminated. In the OTC derivatives business, this third possibility is called cherry-picking.

The bankruptcy question is an important one for two closely related reasons. First, the answer to the question is crucial if one is to perform realistic assessments of credit risk. Such assessments of credit risk allow a bank to judge the riskiness of its portfolio of assets and liabilities. Second, the answer is important if one is to accurately assess the amount of capital that an OTC derivatives dealer should set aside. Although all OTC derivatives dealers need to understand this issue, it becomes one of particular concern to OTC derivatives dealers regulated as banks. National banking regulators and the Basle Committee on Banking Supervision have been grappling with this question for some time.

ISDA Master Agreement

At the center of the ISDA agreement structure is the 1992 version of the master agreement.[5] This document sets out the master agreement structure and incorporates the individual confirmations that spell out the specific terms of each individual transaction. The document includes representations, events of default, termination events, and covenants, and it specifies early termination provisions. The confirmations, which differ according to the form of the transaction, all become part of the master agreement. Also, the document contains a number of definitions that facilitate the creation of confirmations for individual transactions. With this structure, one-page confirmations can be used for a variety of products, including rate swaps, basis swaps, foreign exchange transactions, rate caps and floors, currency swaps, equity derivatives, commodity derivatives, and other derivatives transactions. Finally, ISDA completed work on the 1994 Credit Support Annex,[6] which allows the market value of the netted transactions to be collateralized. This document allows counterparties to (i) net their exposure with each other and then (ii) collateralize the single net exposure. As a result, after netting and upon proper collateralization, both counterparties' net exposure will be zero.

Why Does Netting Work?

The 1992 ISDA Master Agreement states that the parties have entered or will enter into one or more transactions with each other from time to time and will execute and exchange a document or other confirming evidence (each document a "confirmation") setting forth the particular terms of each transaction. It also states that the parties enter into transactions in reliance on the fact that each 1992 ISDA Master Agreement and confirmations relating thereto form a single agreement.

In the event of a default-based termination, the 1992 ISDA Master Agreement allows a lump-sum amount (reflecting the positive or negative values of all transactions) to be calculated in connection with an early termination date (commonly referred to as "close-out netting"). The agreement contains two alternatives for calculating this lump-sum amount upon early termination, which the parties elect at the time that they enter into a master agreement. The lump-sum amount calculated during close-out netting is the netted total of all the transactions entered into pursuant to the master agreement.

If the 1992 ISDA Master Agreement is enforceable in bankruptcy, the exposures of differing OTC derivatives transactions will in essence be set off against each other upon the bankruptcy of one of the counterparties. Hence, if the netting provisions of the 1992 ISDA Master Agreement are enforceable, a series of OTC derivatives transactions entered into under such an agreement only generates the credit risk of the net of these transactions. However, if netting were not enforceable, the credit risk would be the sum of all the out-of-the-money transactions, typically a much higher figure than the net. Consequently, depending on whether netting is enforceable, a series of OTC derivatives transactions between the same two counterparties could create widely different credit exposures.

The Group of Thirty report gave a very clear recommendation regarding documenting and netting. As Recommendation 13 states:

> Dealers and end users are encouraged to use one master agreement as widely as possible with each counterparty to document existing and future derivatives transactions, including foreign exchange forwards and options. Master agreements should provide for payments netting and close-out netting, using a full two-way payments approach.[7]

Why? The explanation is simple; the commentary on the above recommendation notes that

> [a] single master agreement that documents transactions between two parties creates the greatest legal certainty that credit exposure will be netted. The use of multiple master agreements between two parties introduces the

> risk of "cherry-picking" among master agreements (rather than among individual transactions); and the risk that the right to set off amounts due under different master agreements might be delayed.[8]

The rationale is incontrovertible. The commentary also asserts that "there is substantial scope for reducing credit risk by including foreign exchange forwards and options under master agreements along with other derivatives transactions."[9]

There has been a fair amount of discussion over whether the Basle Committee on Banking Supervision should apply netting to the risk-based capital guidelines. In April 1993, the Basle Committee on Banking Supervision released *The Supervisory Recognition of Netting for Capital Adequacy Purposes*.[10] In this consultative proposal, the Basle Committee on Banking Supervision accepted that netting should be recognized for risk-based capital adequacy purposes. It wrote that "the 1988 Capital Accord should be revised to recognize, in addition to netting by novation, other forms of bilateral netting of credit exposures to the extent that such arrangements are effective under relevant laws. . . ."[11]

The release left open the question of whether netting should be applied to the "add-on." The add-on is an extra capital charge required by the 1988 Basle Capital Accord.[12] The purpose of the add-on apparently is to provide a cushion in the event of market movements that might change the value of exposures and, hence, change the level of credit risk during the period from one mark to the next. ISDA believes that there is convincing evidence that netting reduces the chance that market movements will increase credit risk for a portfolio of OTC derivatives. If this is indeed the case, the logic of the add-on calculation would suggest that netting, if enforceable, should reduce add-on requirements as well.

For risk-based capital purposes, the question becomes, To what degree is netting enforceable under relevant laws? Part of the good news is that a number of recent statutory developments have explicitly guaranteed the enforceability of netting in the laws that regulate some of the world's largest economies and most sophisticated financial centers.

In the United States, changes to the U.S. Bankruptcy Code addressed netting with respect to counterparties that were corporations,[13] while amendments to the Federal Deposit Insurance Act in the form of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, a law aimed at the savings and loan industry,[14] and provisions of the Federal Deposit Insurance Corporation Improvement Act[15] have addressed netting with respect to financial institutions whose insolvencies are not governed by the U.S. Bankruptcy Code.

In France, legislation was directed at the netting of debts and claims related to certain markets that are either (i) specifically regulated or (ii) governed by a framework agreement complying with general principles of standard framework agreements governing the relationship between the two parties, at least one of which is a qualified institution.[16] By "qualified institution," the French Parliament meant a French bank, credit, or insurance institution or a foreign entity that was subject to analogous regulation in its home country.

Legislation explicitly permitting netting has also been passed in Canada,[17] Belgium,[18] Germany,[19] and Switzerland.[20] Over half of the Group of Ten (G-10) countries have passed statutes enforcing netting.

In other countries, explicit statutory guidance is sometimes lacking, but the ISDA has spent considerable time and effort attempting to document the extent to which netting under the ISDA Master Agreement is enforceable "under relevant laws." To this end, the ISDA solicited legal opinions from legal counsel in all 11 of the G-10 countries with respect the enforceability of netting under the ISDA Master Agreement.

There are some obstacles to these legal opinions in countries where the law does not explicitly address netting. This situation arises because the relevant laws were enacted before the genesis and growth of the OTC derivatives market, and because there are no cases on point. If there are no cases and precedents directly on point in a country, these opinions are reasoned opinions, that is, they operate from analogy and logic. The ISDA has now finalized legal opinions from all the countries represented on the Basle Committee on Banking Supervision.

One example of a country where netting became well established even without legislation is England. On November 23, 1993, the Financial Law Panel, which is sponsored jointly by the City of London and the Bank of England, issued a guidance notice entitled "Netting of Counterparty Exposure." The purpose of the guidance notice was to provide a clear statement of what is widely agreed by lawyers to be the basic rule of English law: close-out netting for OTC derivatives transactions is a form of setoff that is enforceable in England. This conclusion was confirmed by 23 leading London law firms.

Enforceability of Netting

What can be concluded about the G-10 world and the enforceability of netting? In brief, throughout the countries represented on the Basle Committee on Banking Supervision, netting is the law. If a party to an OTC derivatives transaction is organized in one of the 11 G-10 countries, the counterparty can terminate its OTC transactions upon bankruptcy,

and close-out netting, as embodied in the ISDA Master Agreements, will be enforced.

Multibranch Netting

The basic question of multibranch netting is, What happens when a bank enters into OTC derivatives transactions under a master agreement through several of its branches in different countries? Upon insolvency of the bank, will the assets and liabilities of a given branch be treated together with the rest of the bank, or will the local regulators attempt to deal with the local branch separately? In the United States, this separate approach is known as ring fencing.

Section 10(a) of the 1992 ISDA Master Agreement provides for multibranch netting. At this juncture, the legal opinions gathered do not speak to the issue of multibranch netting; they all address the question of bilateral close-out netting. Nonetheless, the ISDA is not aware of any precedent indicating that officials administering bank insolvencies in G-10 countries would not honor a master agreement with such a provision. Although bankruptcy law in many countries gives the right to assume, reject, or assign executory contracts in bankruptcy, apparently no bankruptcy law permits the amendment of a contract. Therefore, as a matter of contract and insolvency law, it is not apparent how the multibranch provision could be removed from the master agreement. Hence, it is likely that legal opinions would generally confirm that master agreements can create enforceable multibranch netting. If uncertainties exist in some countries, owing to the discretionary powers of banking regulators or other officials overseeing bank insolvencies, clear statements that such powers would be exercised to support the enforceability of multibranch netting arrangements would resolve any doubts.

Until recently, there was a degree of uncertainty concerning the enforceability of a multibranch master agreement that includes branches organized under the laws of the state of New York. New York historically has taken the approach of ring fencing branches chartered under New York law that are placed in receivership by the New York State Banking Superintendent. In July 1993, however, New York adopted legislation[21] sponsored by the State of New York Banking Department that addresses the treatment of "qualified financial contract[s]," including OTC derivatives, entered into by a New York branch or agency of a non-U.S. bank that is placed in receivership by the New York State Banking Superintendent. Under the new New York law, qualified financial contracts are not terminated automatically upon the Superintendent's taking of possession of a New York branch or agency, and the Superintendent

will not assume or repudiate such contracts documented under multibranch master agreements. Instead, the home country regulator of the foreign bank will be allowed to assume or repudiate the multibranch master agreement, and counterparties will be allowed to terminate such agreements in accordance with their terms. This type of legislation provides important legal certainty, and it is to be hoped that similar legislation or rules, if required, will follow in other jurisdictions.

23B. The Risks of Financial Derivatives

KENNETH RAISLER

Introduction

This chapter focuses on the risks of derivatives, which center on the possibility of a default of one of the counterparties. Netting is absolutely critical in this analysis.

There are seven risks associated with derivatives:

- legal risk;
- credit risk;
- market risk;
- liquidity risk;
- operational risk;
- reputation risk; and
- systemic risk.

These risks were identified in the Group of Thirty report on financial derivatives.[1] One of the most important findings of this report is that, at one level and, indeed, at many levels, the risks of derivatives are fundamentally no different from the types of risks associated with traditional instruments, including loans, securities, and deposits. Considering the above list of risks in the context of a product, such as a fixed-rate mortgage with a prepayment option (which is an extremely popular product for homeowners in the United States), one realizes that the same risks associated with derivatives are present for a bank lending fixed-rate mortgages. In fact, it was the inability to manage that fixed-rate mortgage portfolio that was at the core of the failures of so many savings and loans in the United States. It is also important to recognize—and this is the focus of the U.S. Congress, regulatory bodies, and others around the world—that the complexities associated with derivatives give rise to issues of transparency and questions of legal and market linkages that require a higher level of attention.

A point worth making in connection with derivatives is that these products are not new. One of the earlier derivatives products was born of necessity: a bond offered by the Confederate States of America in 1863, during the Civil War. This was one of the more complicated derivatives that one could imagine. A dual-currency bond, it paid either in British

pounds or in French francs. It had a commodity convertible element: the holder had the option of taking 40,000 pounds of cotton, delivered on the Gulf of Mexico. In 1863, that was not a good option for many of the market participants. This bond offering reflected a situation in which the Confederacy was having serious difficulty raising money and Confederate currency had no value in the world market. Consequently, the Confederate Government designed a product paying in recognized currencies and with a commodity element as a way to raise funds. Although the complexity of this product is important and interesting, it had the same core problem that all such products have: complex payout structures do not mean anything if the creditworthiness of the issuer is a cause for concern. In this historical example, of course, the Confederacy lost the war and defaulted on the bonds.

Failure of Management

Senior management of any institution—central bank, corporation, or pension fund—needs to set the standards by which that entity will engage in derivatives and to manage the program that the company then implements.[2] Recommendation 1 of the report of the Group of Thirty provides that

> [d]ealers and end-users should use derivatives in a manner consistent with the overall risk management and capital policies approved by their boards of directors. These policies should be reviewed as business and market circumstances change. Policies governing derivatives use should be clearly defined, including the purposes for which these transactions are to be undertaken. Senior management should approve procedures and controls to implement these policies, and management at all levels should enforce them.[3]

The failure to implement this recommendation has been and will continue to be the cause of the vast bulk of derivatives problems. The key is that the hierarchy of the organization should be familiar with derivatives; otherwise, the institution should not be involved with them. Senior management should not be surprised by any one investment or overall investment strategy that is undertaken by its treasurer's office or any other unit in the institution. For example, one large U.S. corporation identified a substantial loss in derivatives and ended up writing down over $100 million as a result of its investment. Its senior management indicated in a notice to shareholders that it was surprised by the risk and did not understand the impact of that investment. The position of the Group of Thirty would be that this was not a responsible investment for the corporation to make, as senior management did not know what it was doing. Until senior management understands these kinds of investments, the organization should not undertake them. This issue has been identified as

"intellectual risk," the risk generated by an organization's lack of intellectual capacity or know-how to manage a derivatives portfolio. It is also connected with the issue of internal controls, that is, the failure to set the right policies. This derivatives risk often can also be stated simply as a basic failure of management.

Legal Risk

The fundamental aspect of legal risk is the risk that a transaction is not valid and enforceable under applicable law. The law could be that of the home country, that chosen by the parties, or that of the jurisdiction where a bankruptcy filing takes place.

Most countries' legal systems have not kept pace with financial development. This general comment applies not just to derivatives but to all means of financial innovation. Very few cases anywhere have dealt with the issue of the legal enforceability of derivatives. Market participants end up having to work with legal opinions. The ISDA has done a splendid job of collecting these opinions; however, reading them makes one realize that they are not as good as an affirmative statement from a country's legislative body. For this reason, the ISDA and others are pursuing such legislation in order to make sure that an isolated case does not threaten a whole category of derivatives.

Four issues arise under the heading of legal risk:

- bankruptcy and insolvency (netting);
- documentation;
- capacity and authority; and
- legality and enforceability.

The first issue, bankruptcy and insolvency, bears on the enforceability of netting and the critical elements addressed in the previous chapter.

Second, documentation and the use of master agreements are also a key part of the netting process. At its inception, any agreement in the derivatives or any other contract area needs to be put in writing in most jurisdictions to be enforceable. Even in those jurisdictions where all agreements are enforceable, a written agreement helps in a court or other legal context to solidify the parties' rights and obligations.

Third, the capacity or authority of a counterparty to enter into a transaction is absolutely critical to ensure that the transaction is enforceable. Unfortunately, a British case involving the London councils, which are municipalities in and around the city of London, ***Hazell v. Hammersmith***

***and Fulham London Borough Council*,**[4] resulted in a decision by the U.K. House of Lords, the highest court, that the councils did not have authority under their enabling statutes to enter into swaps of any kind. This decision surprised many observers, who felt that swaps entered into by the councils to manage risk should be enforceable. The ISDA conducted a ten-year study of defaults and losses in swaps and found that about half of those losses—$500 million out of approximately $1 billion in total losses—were the result of having to unwind all of the swaps with the councils. This issue involves the authority of not just a London council but also that of all municipalities, pension funds, insurance companies, building societies, and other organizations. Obviously, a wrong assumption in this area could be devastating to an institution that has entered into a transaction, particularly if the result is an unwind and a return to the first position. A dealer in a swap market who has a position between two parties always assumes that the position is matched up; however, if one party defaults and has to unwind, the consequence for the other party is very serious.

Fourth, the issue of legality and enforceability raises the question of whether the derivatives transaction can or will be enforced in court. The Group of Thirty found in its examination that two general areas of law were problematic in many jurisdictions. First, derivatives may in many cases be subject to laws applicable to futures contracts. For example, in the United States, all futures contracts must be traded on a designated exchange, such as the Chicago Board of Trade or the Chicago Mercantile Exchange. There was a concern that, if a swap were deemed to be a futures contract, it would be illegal because it was not trading on a designated exchange. The law in the United States was changed in 1992,[5] and regulations were implemented in early 1993 to largely settle this issue,[6] but the same problem exists in other countries. An unfortunate case in Australia highlights this issue.[7]

The second problematic point on legality and enforceability is the possibility that in many countries derivatives may be seen to violate a gambling statute or a statute that requires that such trading occur on a licensed exchange. These statutes, which have been on the books for a long time, concern a bet of some kind on a future event whose outcome is not controlled by one or the other party. In the United States, this problem has largely been solved by legislation. However, the examination by the Group of Thirty indicates that, in countries such as Australia, Brazil, Canada, and Singapore, there are uncertainties as to whether derivatives violate relevant statutory provisions.[8]

This issue is evolving, and significant new developments and changes can be expected. The Group of Thirty focused on making recommenda-

tions to deal with legal and regulatory uncertainties. They have recommended that

> [l]egislators, regulators, and supervisors, including central banks, should work with dealers and end-users to identify and remove legal uncertainties with respect to:
>
> - The form of documentation required to create legally enforceable agreements (statute of frauds).
> - The capacity of parties, such as governmental entities, insurance companies, pension funds, and building societies, to enter into transactions (ultra vires).
> - The enforceability of bilateral close-out netting and collateral arrangements in bankruptcy.
> - The enforceability of multibranch netting arrangements in bankruptcy.
> - The legality/enforceability of derivatives transactions.[9]

Credit Risk

Credit risk is the risk of loss if a counterparty defaults. The key point from the standpoint of a company's internal controls is that the company should measure the associated costs of replacing a derivatives transaction, in addition to the potential replacement cost itself. Thus, in evaluating its overall exposure to credit, a company must take into account the possibility that the market may move between the time of default and the time that it is able to replace the particular transaction.

The other key element in the credit risk recommendations of the Group of Thirty is that credit risk management has to be independent from the trader who put together the original transaction.[10] The incentive of the trader to do the transaction may make it difficult to take into account fully the extent of the credit exposure. An independent credit risk manager is the correct person to evaluate whether it is the right kind of transaction for the company.

In this regard, two additional points should be made. First, greater use is being made of collateral, and the 1994 ISDA Credit Support Annex will be a big help in this regard. Institutions such as the World Bank have made public their interest in moving more generally to collateralizing their swap portfolio as a way of substantially reducing and managing this risk. Second, there is talk in the press—more than in corporations and other institutions—about developing a clearinghouse for swaps and other kinds of derivatives transactions. This undertaking would be very difficult, but a number of people are looking into it.

Market Risk

Market risk is the risk associated with a decline in the value of a derivatives instrument. An example of this kind of stress situation would be the U.S. stock market crash of October 1987. Market participants need to calculate their market risk when evaluating their potential credit and other risk exposure by marking their positions to market at least daily. Participants may assume that the market will move within historic limits in making these calculations. Dealers should also mark positions to market at least daily.

Liquidity Risk

Liquidity risk is the risk that, because of market movement, a counterparty will be unable to meet its net funding requirements. More specifically, it is the risk that, because of liquidity strains in the market, there will not be a fair price, that is, the price between the bid and the offer will be so wide that there may be no real market in which the participant can sell or buy the position that it is trying to replace. Liquidity risk has been a problem with more complex derivatives instruments. In the United States, for example, one organization saw its portfolio value drop from $600 million to near zero overnight when trying to sell it. Although the company thought that it had made reasonable assumptions about the portfolio's value, the absence of liquidity in the market meant that there was no buying market for its interests.[11] This risk is obviously something that needs to be evaluated.

Operational Risk

Operational risks are the risks associated with human error, systems failures, or inadequate procedures and controls. It is the responsibility of senior management to set the parameters and design and implement proper back-office procedures and other technological programs to counteract this risk. The absence of these internal controls, as well as the resulting operational risk, are unacceptable for any derivatives participant. Prospective participants should not enter the business until such systems are in place.

Reputation Risk

Reputation risk, a sort of summary risk, is a risk that market participants deal with every day. A market participant might lose clients or gen-

eral reputation in the market if it does not deal fairly with them or does not properly manage its business. This risk might also be characterized as the risk of professional embarrassment.

Systemic Risk

Systemic risk is very difficult to define; it is the risk on which legislators, central bankers, and regulators have been focusing. There is no real evidence to support the scope that has been attributed to this risk, but it is a valid issue at the theoretical level. It is based on the "domino theory," that is, the idea that the failure of one institution will cause failures in a series of other institutions or create a marketwide disruption in the financial system. This would be the catastrophic event that nobody looks forward to or anticipates but is always a possibility. Systemic risk is the focus, in fact, of the U.S. General Accounting Office's report on financial derivatives.[12]

The elements of systemic risk are hard to identify. First there is the question of the size and complexity of the market. The press reports notional amount exposures; however, those amounts of $12–14 trillion do not reflect the real risks in the market. A smaller number, $68 billion, has been calculated as the percentage of the overall exposure that banks have in their loan and other portfolios. Second, there is a concern about concentration, based on the limited number of dealers in the market. However, statistics show that no one dealer has more than 10 percent of the market.[13] There is, in fact, a wide dispersion of involvement among both dealers and end users. Third, the lack of transparency in the market is a cause for concern. In this respect, the accountants have not kept up with financial innovation. It is to be hoped that progress will be made in providing more information. Fourth, there is a somewhat vague concern that certain entities in this market are unregulated. The authors of the General Accounting Office report, for instance, have identified this as a problem. Fifth, there are concerns that the products are unusual and therefore illiquid—a point that has previously been addressed. Finally, there is the concern that the markets are linked and that, because of technology and innovation, a negative impact on one player in one part of the market will spread to other markets. How is this risk to be dealt with? Necessarily, other elements of systemic risk include credit risk and legal risk, which have already been addressed. The hope is that progress will be made in getting a handle on each of these incremental elements. In any event, the appropriate response to systemic risk should be one of concern but not overreaction.

Legislative and Regulatory Risk

Legislative and regulatory risk (a risk not formally on the list presented at the beginning of the chapter) is the potential for overreacting to the risks of derivatives. Derivatives lawyers have expressed concern over the legality of certain transactions because of the difficulty of determining how they fit in a legislative or regulatory scheme.[14] Here, the concern is—and the General Accounting Office's report recognizes this—that, if any one country imposes rigorous new regulatory or legislative requirements without proper international coordination, the market can successfully move to another jurisdiction, with destabilizing effects.

There is also the concern that, without international coordination, new regulatory or legislative requirements will accomplish nothing other than to dampen the utility of products that provide very important benefits, not just to end users who can manage their portfolios, but also to the dealers, for whom derivatives represent a strong source of profitability. It is possible that new requirements would hamper certain players' use of derivatives. Regulators or legislators might impose suitability, disclosure, and capital requirements, all of which potentially have an impact on the ability of participants to use the market. Lack of adequate disclosure, certainly, is something that the marketplace is attempting to correct; the hope, however, is that legislators or regulators will not overreact in a way that will destabilize the business.

COMMENT

DAVID FOLKERTS-LANDAU

The absence of legally binding netting arrangements is a pernicious factor that could aggravate a distress situation or a default in the derivatives market. In a typical situation, the counterparty of the dealer has a number of claims against the dealer implicit in the over-the-counter (OTC) contracts held by the counterparty, who will at the same time owe a number of payments or claims to the dealer. Any doubt about the dealer will immediately translate into tardiness on the part of this counterparty in paying the obligations to the dealer. The immediate result would be a liquidity crisis, as the counterparty would simply postpone the payments until a more propitious time. Sorting out legal enforceability would occur much farther down the road. That is the nature of the problem: without netting arrangements, a counterparty can selectively hold back payments that are legally due to the dealer or to another institution on the other side of the transaction. Netting helps to eliminate that possibility and thereby reduces the possibility of systemic risk through a seizing up of payments.

Legality of Netting

A key question is whether it is possible to construct legally binding netting schemes. One should bear in mind in this respect that netting schemes, if there is doubt about their legal enforceability, may be worse than no netting schemes at all. When there is no netting scheme, one can assess the situation accurately and take steps accordingly. However, when one has a netting scheme but does not quite trust it, one cannot make an accurate assessment of risk or deal with it with certainty.

A legislative solution is the only satisfactory way to achieve the necessary level of certainty. Such a solution should optimally be encouraged at the international level. It can be achieved through extensive bilateral efforts or perhaps a multilateral effort spearheaded by the Bank for International Settlements. Absent specific legislation in the relevant countries, however, one cannot be certain that netting is legally binding in the OTC markets. In this regard, the U.S. experience probably provides a good precedent.

In the United States, pre-emptive federal legislation contained in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989,[1]

the amendments to the Bankruptcy Code,[2] and Subtitle A of Title IV of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)[3] have gone a long way toward legalizing netting. Interestingly, Title IV of FDICIA covers multilateral as well as bilateral situations. The impetus for this legislation was the Herstatt Bank case and what it did to the foreign exchange transactions of the Clearing House Interbank Payments System (CHIPS). There was no netting in place at the time. Herstatt closed when the American markets were still open, and it had not yet made its payments even though counterparties overseas had made payments. This incident caused a major problem for CHIPS and raised the concern of the U.S. central bank.

When considering situations such as the Herstatt case, the following question should be raised: If a foreign bank fails, will a receiver in that country honor CHIPS's contractual arrangements? Some may, but some may not. Because OTC and foreign exchange markets are international markets (they are not exclusively U.S. or U.K. markets), the international dimension looms large. The fact that market participants and regulators should be concerned about the actions of receivers on the other side of the border shows how fundamental bilateral netting efforts are.

Advantages of Multilateral Clearinghouses

A basic question about the architecture of the derivatives market is why roughly half of all derivatives activities are carried on in the OTC market and half on the futures exchanges. The usual answer given is the need to customize derivatives transactions. However, this answer is wrong; an examination of the swap book—and swaps account for close to 60 percent of all transactions—reveals that in excess of 75 percent of all swap deals are standard deals with maturities of 1, 2, 5, 10, and 15 years. Also, despite the large volumes, there are only about a dozen dealers. Their staffs cannot possibly customize the $1.5 trillion in documents underlying the swaps. Therefore, even without looking at the books, one knows that a tremendous amount of standardization must be taking place.

Why is a particular contract not traded on the exchange as a swap contract? What are the advantages offered by a multilateral clearinghouse structure? Two advantages are (i) liquidity and (ii) the lack of credit risk. With respect to the first advantage, the exchange can become, in effect, the counterparty to contract trades on the exchange if the primary party fails to perform. The contract is thus fully fungible; it is no longer merely an unsupported bilateral contract between the dealer and its counterparty. The contract becomes liquid, like a futures contract. Second, with respect to credit risk, an exchange requires a mark to market on a peri-

odic basis, traditionally at the end of the day, through its automatic and explicit margining requirements.

The current market structure has functioned well through times of tremendous stress, growth, and diversity. Why is there so much activity in a market that has significant faults and is subject to significant risks? Part of the answer is resistance from the industry, particularly those dealers that have an AAA rating. If they participate in a clearinghouse, they will lose the comparative advantage derived from their rating. The clearinghouse itself would, in effect, be rated; presumably, because of its risk-management features, it would receive an AAA rating. One reason why, despite the objections of the dealers, the OTC market or a large portion of it continues to exist can be found in the current structure of capital requirements for banking institutions. The associated costs of replacing a defaulted transaction may approximate the amount of margin money that would have to be paid if these contracts were traded on an exchange. Those costs, which would be funded by banks and would show up on their balance sheets, must reflect an 8 percent capital requirement. Effectively, then, participants avoid a capital charge by using an OTC market.

Pressure is now building from several sources to move toward a clearinghouse approach. First, pressure comes from the industry itself, because several large players have found that their exposure to the dealers is full. Essentially, they are running out of counterparties with the dealers and, therefore, pushing for multilateral clearing arrangements with or without counterparty features. Second, pressure is coming from the exchanges themselves, which are introducing products to allow flex options and other features that resemble those in the OTC market. Some of the liquidity element may be lost as flexible features are introduced, because the product will be more fungible; this problem will have to be addressed. Third, in the foreign exchange market, very serious efforts are under way to create multilateral clearinghouses—the European Clearing House Organization's Exchange Clearing House Limited and the North American Clearing House Organization. Such efforts are growing, and a structure is emerging.

The derivatives industry has been immensely beneficial to the world at large. The efficiency gains, the pricing gains, and the liquidity gains have been incomparable. The importance of derivatives in this century is equivalent to the establishment of limited liability in the nineteenth century. That is why trying to make changes at the margin to deal with risks is probably not very satisfactory. That is why the multilateral clearinghouse approach should be encouraged. The efforts that must be made for this approach to work are enormous. By way of example, the legal aspects

of multilateral clearing and the status of clearinghouses are several times more complex than those involved in bilateral netting.

In thinking about the supervisory and regulatory aspects of derivatives markets and their architectural design, one should take a close look at the advantages offered by a multilateral clearinghouse structure. Such a structure would take the activity that can be standardized out of the banking system and relieve banking supervisors of the burden of having to watch over it.

Chapter

24 Securitization: Has It Matured?

MARK J. WELSHIMER

Introduction

Securitization has become an endeavor dependent upon acronyms and technology. There are MBSs, ABSs, CMOs, REMICs, IOs, POs, PACs,[1] and a host of others—all acronyms for various kinds of securities, many of which would be difficult if not impossible to create, describe, evaluate, and understand without the increasingly sophisticated modeling capabilities made possible by computers. Accordingly, securitization is a financial and securities product that the computer age has made possible.

The focus of this chapter is on the general concepts underlying securitization, the factors that have impacted on its growth and development and may impact on its future growth and development, and the benefits and risks to financial institutions and other parties that participate in various parts of the securitization process (as well as the marketplace generally). This chapter will not dwell on the more exotic products (some of which create a variety of significant benefits, and some of which create significant risks) that the market wizards have created. It also avoids overconcentration on the technicalities of the U.S. legal and regulatory framework affecting securitizations. However, that framework, particularly insofar as banking regulation and tax and securities laws are concerned, has had a significant impact on the pace of development of the securitization markets in the United States and the direction that they have taken. Moreover, the U.S. legal and regulatory scheme has analogies in other countries. Accordingly, securitization—in the United States and elsewhere—cannot be understood without some reference to that framework.

This chapter has five basic themes: (i) securitization is a significant activity in the United States with important consequences for the health of the financial system, as well as for the liquidity of banks; (ii) securitization generally has been a positive development; (iii) commercial banks, because they are the major originators of securitized assets, have been and will probably continue to be at the center of developments in the area; (iv) as an activity, securitization has for the most part matured in the United States; and (v) in the short term, there is likely to be some

retrenchment in securitization, as the instruments offered to investors are likely to become more rather than less standard.

What is securitization? The basic concept is simple. Securitization fundamentally involves the process of taking relatively illiquid assets originated by financial institutions and repackaging them into securities that can be sold to capital markets investors; hence the term "securitization." The objective customarily is to create a security that capital markets investors can analyze and invest in by focusing only on the risk characteristics of the underlying assets and the structural implications, both legal—taxes, for example—and purely financial—prepayment risk, for example—of the transaction. Generally, there must be no material risk that, if the seller of the underlying assets has financial difficulties, the securities purchased by investors will be adversely affected. Accordingly, it is important to be able to conclude that, if the seller of the underlying assets ultimately does become bankrupt or get into financial trouble, the securities sold to investors and the investors' indirect interest in the underlying assets will not be affected under applicable bankruptcy and insolvency laws.

Mortgage-backed securities (MBSs) are securities supported by mortgage loans (generally residential mortgage loans). The term "asset-backed securities" (ABSs) is sometimes used by practitioners to mean securities supported by assets other than mortgages, and it is sometimes used to encompass the entire world of securitization—both securities backed by mortgages and securities backed by other assets.

Although precursors to securitization date back to the nineteenth century, the modern day market in MBSs and ABSs in the United States is not really that old. MBSs began in the early 1970s when the Government National Mortgage Association, a government-sponsored entity, issued the first pool of residential mortgage loans, in which the pass-through certificates purchased by investors benefited from a U.S. government guarantee. The first private MBS offering (in the form of a single class of pass-through certificates) backed by residential mortgage loans involved the Bank of America as seller-sponsor in 1978. The world of non-MBS ABSs began in 1984 with the first two public offerings of ABSs backed by automobile loan receivables, one by Marine Midland Bank as seller-sponsor (with Salomon Brothers as underwriter), and the other by Valley National Bank as seller-sponsor (with First Boston as underwriter). Both offerings took the form of pass-through certificates, identical in structure in all material respects to the mortgage pass-through certificates issued to date.

Since 1984, securitizations have been accomplished using a variety of other types of underlying assets and receivables, including credit card

receivables, first securitized by Republic Bank Delaware in 1987; boat loans, first securitized by Chemical Bank in 1988; recreational vehicle loans, first securitized by Fleetwood Enterprises in 1988; equipment leases, first securitized by Sperry Lease Finance Corporation (using leases on data processing equipment) in 1985; and nonperforming loans and other real estate loans, first securitized by Mellon National Bank through Grant Street National Bank in 1988. In addition, junk bonds, highly leveraged transaction or HLT loans, and tax-exempt bonds have been used in securitizations.

As the scope of securitization expanded, the development ultimately having the greatest impact was the first securitization of credit card receivables. This development was important because credit card receivables, given their revolving nature, could not simply be securitized in the normal form, namely, by placing a pool of identified receivables in a trust and passing through payments on the receivables to the investors when received. If that form were used, the trust would liquidate in very short order (six months or less).

MBSs and ABSs, taken together and based on new issuances, are much larger than the corporate equity market. MBSs and ABSs are closing in on the overall corporate market (corporate bond and stock offerings lumped together) as the second-largest securities market in the United States after government securities. Approximately $418 billion of MBSs (by principal amount) were issued in 1993 alone, and nearly $1.3 trillion in the five years ended December 31, 1993. At the end of 1993, well more than $1.5 trillion in MBSs were outstanding. With respect to ABSs, approximately $59.5 billion were issued in 1993, and more than $225 billion in the five years ended December 31, 1993. By comparison, corporate equity and bond offerings in 1992 totaled approximately $560 billion ($472 billion of bonds and $88 billion of stocks).

The securitization market in the United States is more developed than elsewhere, although the markets in a number of other jurisdictions are developing quickly. The U.S. head start is largely the result of two factors: U.S. government policies favoring the development of a secondary market for residential mortgages; and the deregulation of interest rates payable by U.S. banks and savings associations in the early 1980s. However, securitization as a financial activity is already quite significant in the Euromarkets and in several other countries' domestic markets. Standard & Poor's reported in April 1991 that, since 1987 (when it rated its first non-U.S. structured financing), it had rated over 100 non-U.S. issues, totaling approximately $28 billion and involving assets originated in seven countries. Anecdotal evidence indicates that securitization has grown exponentially in Europe over the past several years. The Bank of

England's 1989 notice on "Loan Transfers and Securitization" removed some of the uncertainties surrounding the treatment of securitized assets for U.K. banking regulatory purposes. France has promulgated a legal and regulatory framework targeted specifically to securitizations.[2] Sweden, given the important role of its Government in supporting and assisting the construction of new housing, seems to be the birthplace for mortgage securitizations in continental Europe, and Japan has devoted a number of research committees, both in and out of its Government, to studying securitizations for a number of years.

Banks and Their Objectives

Commercial banks and thrifts (including their mortgage banking subsidiaries) tend to be the largest sponsors of securitizations, followed by the large, captive finance subsidiaries of the automobile manufacturers. The reason is self-evident: these entities are the originators of the assets, and, particularly in the case of banks, they are under intense competitive pressure to generate predictable earnings streams while limiting risks. Their interests and needs have been and will continue to be the principal determinants of developments in the U.S. securitization markets.

Securitization is essentially a large-scale disintermediation, in which traditional bank lending funded by deposits is replaced by the funding of the same assets directly by the capital markets. There are six principal incentives and objectives that have pushed seller-sponsors to securitize.

- ***Credit risk*** with respect to the underlying assets can be transferred to third parties (whether the MBS or ABS investors or credit enhancers).
- Capital markets can be accessed as a source of ***liquidity***.
- As part of its task of managing assets and liabilities, a seller-sponsor can reduce ***maturity risk***, the risk that a financial institution will not be able to match perfectly the funding of assets and liabilities on its balance sheet. In a securitization, there is no maturity "gap." Additionally, prepayment risk is transferred to investors (except to the extent of the servicing fee income that the seller-sponsor, in its separate capacity as servicer, may expect to receive).
- Like maturity risk, any ***interest rate basis risk*** for the seller-sponsor can be eliminated and transferred (collectively) to the investors in the securitization.
- *Cost savings* can be generated by a securitization, as the securities can be structured (including through "overcollateralization," extrinsic

credit enhancement, or both) to obtain a higher credit rating for the MBSs or ABSs than the originating entity itself would obtain, effectively resulting in a lower cost of funds.

- Seller-sponsors can produce *fee income* without having to fund the related assets and bear the risks of ownership and funding described above. The seller-sponsor of the securitization customarily will act also as servicer and will receive, as servicing compensation, a designated percentage of the balance of the underlying assets from time to time outstanding. The servicing fee is funded from the excess of the interest rate received on the underlying assets over the interest rate paid on the securities being issued.

Critical Developmental Factors

Undoubtedly, a variety of direct and secondary pressures, including the factors referenced above, have borne on the development and growth of securitizations, particularly the dramatic growth that began in the late 1970s. Banks were under pressure to reduce assets; accordingly, they required capital that generally (even before risk-based capital requirements were introduced) was determined in connection with some measure of assets. Banks were also under pressure to generate fee income and manage risk generally.

As indicated above, two factors were particularly important in the growth of securitizations in the United States: (i) U.S. government policies favoring the development of a secondary market for residential mortgages, reflecting to some extent the importance traditionally assigned to home ownership in the United States; and (ii) pressures resulting from the deregulation of interest rates payable by U.S. banks and savings and loan associations in the early 1980s (as mandated by the Depository Institutions Deregulation Act of 1980).[3]

U.S. Policies Supporting the Residential Mortgage Market

Government support for the residential mortgage market is manifest in a host of ways. Perhaps the most important and fundamental was the creation by statute of the Government National Mortgage Association (a wholly owned corporate instrumentality of the U.S. Department of Housing and Urban Development), the Federal National Mortgage Association (a federally chartered and privately owned corporation first established in 1938), and the Federal Home Loan Mortgage Corporation (a federally chartered corporation created in 1970, the stock of which is owned by the Federal Home Loan banks). These agencies were charged

with developing a secondary market for mortgage loans and given the power to issue their own MBSs. It has been estimated that today approximately 40 percent of new originations of residential mortgage loans are eventually packaged into MBSs issued or guaranteed by these three agencies.[4]

Beyond the creation of these agencies, government policies have been supportive of mortgage credit in many other ways. First, in 1984, Congress passed the Secondary Mortgage Market Enhancement Act,[5] which relaxed, among other things, usury limits, state "blue sky" and securities regulations, and legal investment limitations on mortgage-related securities applicable to a variety of financial institutions (including banks, savings and loan associations, and insurance companies). Mortgage-related securities, for this purpose, are essentially MBSs supported by residential mortgage loans and issued by banks, savings and loan associations, insurance companies, and other institutions that (i) are rated in one of the two highest categories by a nationally recognized rating agency and (ii) are supported by first liens on the underlying real property.

Second, the real estate mortgage investment conduit (REMIC) provisions[6] were added to the Internal Revenue Code in 1986 to permit the issuance of multiclass mortgage-backed securities in qualifying transactions without treating the issuer (whether a trust or some other vehicle) as an association taxable as a corporation (that is, without imposing federal income tax on the issuer).[7] As will be addressed later, this action removed a major impediment to improving the economic efficiency of MBSs; the seller-sponsors had been unable under applicable U.S. federal tax law prior to 1986 to issue in securitizations multiple classes or tranches of securities. Although comparable relief has been discussed for some years for non-mortgage-backed ABSs, legislation has not yet been enacted and does not appear imminent.

Third, Federal Reserve regulations support the development of a secondary market for residential mortgages. The Federal Reserve Board's Regulation D requires that reserves be maintained against certain kinds of "deposits" (defined broadly under this regulation to include most liabilities) of depository institutions.[8] Prior to December 1990, Regulation D included a 3 percent reserve requirement on time deposits having maturities of less than 18 months. Accordingly, MBSs issued by a trust sponsored by a bank that retained a subordinate interest or otherwise provided credit enhancement generally would have been treated as a "deposit" of the bank, subject to reserve requirements. However, the current (1995) version of Section 204.2(a)(2)(ix) of Regulation D

includes an express exception for a retained interest not exceeding 10 percent in pools of conventional residential mortgage loans.[9]

Finally, the risk-based capital requirements of the U.S. banking regulatory agencies favor mortgage loans and MBSs in a variety of respects. Most important is the 50 percent risk weighting available for high-quality residential and multifamily mortgage loans (as well as for MBSs backed by such loans).

Deregulation of Interest Rates

Depository institutions in the United States had been subject prior to the 1980s to limits on the interest rates that they could pay on various kinds of deposits. These limits were implemented through the Federal Reserve Board's Regulation Q.[10] In the early 1980s, the interest rate ceilings were effectively eliminated, introducing for the first time real competition for deposits and creating the specter of significant mismatches between interest earned on long-term, fixed-rate assets (the largest single component of which were residential mortgage loans) and interest paid on deposits at competitive rates. The incentive to manage interest rate risk by intermediating between capital markets as a long-term funding source and mortgage borrowers was a very important component in the push by banks, commencing with Bank of America in 1978, to develop the private (that is, nonagency) MBS market.

Characteristics of Assets Affecting Securitizations

Although any kind of loan, receivable, or other asset that generates a cash flow stream can, in theory, be repackaged into a security, as a practical matter it is much easier to securitize assets that are more (rather than less) homogeneous, and to securitize when each asset is only a small part of the entire pool of assets that supports an MBS or ABS. Legal and regulatory factors, which will be addressed below, are likely (at least in the near term) to constrain the expansion of ABSs into new types of assets. However, equally important is the practical difficulty of the marketplace in coming to grips with less homogeneous assets (commercial mortgage loans, for example, and, to an even greater degree, commercial and industrial loans) that, because of their lack of homogeneity (and often this less predictable loss and delinquency experience), produce less predictable cash flows. The less predictable are the cash flows generated by the underlying assets, the more protection against loss is required by investors in the securitizations. For example, the Resolution Trust Corporation, the U.S. government agency created to administer the resolution of failed savings and loan associations, was by far the largest

seller-sponsor for securitizations of performing commercial mortgage loans during 1993. The transactions succeeded because the Resolution Trust Corporation provided recourse, in the form of liquidity reserves, in amounts of between 30 percent and 40 percent of the securities sold. The need for substantial credit enhancement that cannot be satisfied by excess servicing (the difference between the interest rate demanded by investors and the interest rate borne by the underlying assets) precludes as a practical matter commercial banks from participating as seller-sponsors in similar transactions, at least if the selling bank proposes to get sale treatment for regulatory accounting and capital purposes.

To summarize, a number of characteristics facilitate securitizations:

- *Predictable cash flows*, which are partly a function of the nature of the underlying assets and partly a function of their contractual terms, facilitate securitizations. For example, residential mortgage loans in the United States generally must be prepayable at the borrower's election (subject to limited exceptions). A large amount of data is available with respect to prepayment experience on fixed-rate residential mortgage loans. An extraordinary amount of effort and expense (and technology) is devoted to trying to predict the likely prepayment experience on mortgage pools and related MBSs in different interest rate scenarios. There is significantly more basis for analyzing and extrapolating likely prepayment experience on fixed-rate residential mortgage loans than on many other kinds of assets that might be securitized (commercial loans, for example). As to the contractual terms, fully amortizing, level-payment obligations are the most easily securitized. "Balloon payments" (that is, large, unamortized balances due at maturity) and other nonlevel payments lead to nonuniform cash flows to investors. Furthermore, obligations with balloon payments are thought to be more likely to default (because of the uncertainty as to whether the borrower will be able to refinance at maturity). Similarly, assets bearing a fixed interest rate are generally easier to securitize than variable-rate instruments.
- A history of *consistently low delinquency, default, and loss levels* facilitates securitization. The level of credit enhancement required is generally based on an estimate of the performance of the asset pool under "worst-case" scenarios or stressful economic conditions. Although the performance of a pool will be impacted by a variety of factors that may have nothing to do with the historical performance of similar pools originated or serviced by the same seller-sponsor, the level of uncertainty is reduced if the seller-sponsor of the assets has originated and serviced similar obligations in a consistent manner

over a long period of time and has maintained accurate records or payment histories and loss experience on such obligations.

- *Demographic and geographic diversity of obligors on the assets* facilitates securitization. Demographic diversity is particularly important in the case of consumer receivables, in order to mitigate the effects of regional economic downturns; geographic diversity is important in the case of mortgage loan securitizations, in order to mitigate the risk of natural disasters (for example, earthquake risk in California or hurricane risk in Florida).
- A *greater seasoning of assets* facilitates securitization. Experience has shown that delinquency and loss levels are generally highest during the early years, particularly for installment obligations. The greater the "seasoning," or average age, of the obligations, the lower is the expected delinquency rate.
- *High liquidation value and utility to the obligor of the underlying collateral* facilitate securitization. This is a particularly important positive factor for MBSs, for which ultimate losses on foreclosure have historically been relatively small, and on which obligors have a great incentive to avoid defaults (and keep their homes). Credit card securitizations are at the opposite end of the spectrum; they are generally unsecured. The risks for credit card securitizations are offset by the small proportion of the total pool accounted for by each receivable and by the well-developed databases for delinquency and loss experience of the major originators.
- *Standardized, high-quality underwriting and collection policies by the seller-sponsor and servicer* facilitate securitization.

Conversely, a number of asset characteristics make securitizations difficult:

- A *small number of assets in the collateral pool and a high ratio of the largest asset to the average asset* make securitization difficult. The more "large" assets in the pool, the more concentrated is the risk to investors from particular assets, and perhaps the greater the need for asset-specific disclosure.
- A *lack of standardized documentation for the assets* makes securitization difficult. Less standardized documentation is likely to be accompanied by less standard (and predictable payment) terms, as well as by less certainty as to the servicer's rights and remedies upon default.

- *Infrequent payment dates* increase the difficulty of securitization. The capital markets generally require payments on a quarterly or monthly basis.
- The *ability of asset obligors to modify payment terms* (interest rate formula elections, for example) makes securitization difficult. This contributes to greater uncertainty about the cash flow available to service securities.
- *The absence of sufficient historical loss and delinquency experience* for the asset type or for the seller-sponsor increases the difficulty of securitization.
- An *inexperienced or undercapitalized servicer* makes securitization difficult.

These characteristics make it much more difficult to analyze the expected cash flow stream from the asset pool on an actuarial basis and are likely to engender a need for substantially greater credit enhancement or recourse on the part of the seller-sponsor.

The Securitization Process

Elaborating on the definition proposed at the outset of this chapter, securitization can be described as a process whereby a pool of assets with similar characteristics is "packaged" into securities that either pass through or pay principal and interest to security holders, based on and derived from the principal and interest (and sometimes disposition proceeds) from and on the underlying assets. Generally, the monies received from payments on the assets in the pool are the source of funds to pay interest on (and retire) the securities. The product of the securitization might be a pass-through interest in a pool of assets, which is a beneficial ownership interest—not necessarily pro rata with every other beneficial ownership interest—in the pool entitling the holder to periodic distributions of available funds up to specified amounts. Traditional mortgage pass-throughs, for example, are in this category. Alternatively, the product of the securitization might be an actual debt security issued by a legal entity (a special-purpose corporation or an owner trust, for example).

Notwithstanding its young age, the market for MBSs and ABSs in the United States is relatively mature. Most assets that are material assets for financial institutions and that, given their characteristics, can be securitized are in fact being securitized in significant volume in a market-efficient way. These assets include mainly residential mortgage loans, home equity loans (including both term loans and revolving credits), credit card receivables, and automobile receivables. These assets generally

have characteristics that facilitate securitization, as explained above: predictable cash flows, standardized documentation, low weights in the collective assets pool, and valuable collateral (except for credit card loans). Additionally, except for residential mortgage loans, these assets are essentially consumer loans, on which the interest paid by consumers exceeds significantly the interest rate that will be payable on ABSs resulting from a repackaging of the assets into a security.

Basic Structure

Because securitization is simply the repackaging of loans and other receivables into securities, the scope of what falls under this term—the types of issuing vehicles and the types of securities issued, for example—is quite broad. It is not particularly useful to spend much time exploring the intricacies of alternative structures of securitization.[11] Instead, this chapter focuses specifically on the most common structure used in the United States (a "grantor" or "pass-through" trust) as a way of illustrating the impact of the U.S. legal scheme on the development of securitization and the risks and benefits to the parties involved.

In a typical pass-through trust[12] transaction, the relevant parties are (i) the seller-sponsor, the customary originator of the assets; (ii) the servicer, (often but not necessarily the same party as the seller-sponsor); (iii) the trustee (generally a bank) that holds the assets and issues pass-through certificates evidencing interests in them; (iv) one or more underwriters or placement agents distributing the ABSs; (v) in many cases, a "credit enhancer," charged with issuing a letter of credit or surety bond or funding a cash collateral account to protect investors against some multiple of the expected risks; and (vi) the investors themselves.

Typically, the following basic steps occur at about the same time in the securitization process: the seller-sponsor will convey the assets to the trustee in return for pass-through certificates (which may or may not be in multiple classes), evidencing 100 percent of the ownership interests in the trust that holds the assets; the credit enhancer (if any) will issue its letter of credit, surety bond, or other similar instrument to the trustee (or fund a cash collateral account held by the trustee) for the benefit of certificate holders; the seller-sponsor will sell some or all of the certificates to the underwriters, pursuant to an underwriting or purchase agreement; and the underwriters will resell certificates purchased by them to ultimate investors.

Responsibilities of Parties to the Securitization

The operative agreement under which the assets are transferred to the trustee, the trust is created, the servicer is retained to service the assets,

and the pass-through certificates are issued is customarily called a pooling and servicing agreement. Under the agreement, the seller-sponsor, servicer, and trustee take on a number of obligations. The seller-sponsor, in connection with its conveyance of the assets to the trust under the pooling and servicing agreement, typically makes a variety of representations and warranties as to the characteristics of the assets, their enforceability, and their compliance with law, but not as to their collectibility or value. If it turns out that those representations and warranties are breached with respect to one or more of the assets, the seller-sponsor customarily will be obligated to repurchase the assets to which a representation or warranty was breached.

The pooling and servicing agreement will generally spell out the duties of the servicer with respect to collecting payments of principal and interest on the assets, the standard of care that it should apply, and the flexibility given to it to deal with assets that ultimately become troubled or go into default. Moreover, in order to "smooth out" the cash flow going to investors in the pass-through certificates, the servicer will normally be obligated to make out of its own funds "servicer advances" on payment dates for the pass-through certificates to cover delinquencies in payments of principal or interest scheduled on the underlying assets, but only to the extent that the servicer determines that the delinquent payments will ultimately be recovered. The servicer undertakes this obligation because, for a variety of innocuous reasons (borrowers may be on vacation or forget to pay their bills for a week, for example), payments by the obligors (generally individuals) on the underlying assets may not come in exactly when they are supposed to; in these circumstances, the late payments do not reflect credit concerns. If, however, the servicer ultimately concludes that a delinquent payment is not recoverable, the servicer will be entitled to reimburse itself for servicer advances out of the next available cash flow from all the assets.

The pass-through certificates issued by the trust evidence beneficial ownership interests in the underlying assets and an entitlement to specified cash flows from those assets. The terms of the pass-through certificates can be simple or complicated. At the simple end of the spectrum is a transaction in which a single class of pass-through certificates is issued, with each certificate representing an undivided pro rata interest in, and entitlement to, principal and interest payments received on the underlying assets in each period. At the complicated end of the spectrum, generally represented by multiclass MBSs, a large number of separate certificate classes (sometimes as many as 15 or 20) may be issued by a single trust, with each class having different payment entitlements. These might include, for example, sequential pay classes (in which principal payments on the underlying mortgages are applied in sequence to classes until one

class after another is retired, with the consequence that the later classes are riskier), as well as interest-only classes (IOs), principal-only classes (POs), planned amortization classes (PACs), and a host of others. Clearly, computer technology plays a critical role in orchestrating these payments.

The trustee's role in pooling and servicing agreements is customarily fairly limited. The trustee (i) holds record title to the assets, (ii) receives from the servicer collections of principal and interest on the assets, and (iii) pays to the appropriate classes of investors their respective entitlements to the cash flow received from the assets. If the servicer defaults in performing its obligations (for example, fails to remit to the trustee on behalf of certificate holders in a timely manner payments on the underlying assets), the trustee customarily would have the right (and under some circumstances the obligation) to dismiss the servicer and itself act as a backup servicer until a replacement is found.

Role of Law and Regulation

Securitization in the United States is a legally intensive exercise. The principal legal and regulatory areas involved are tax, banking, securities, and bankruptcy and insolvency. The legal and regulatory framework in the United States has had a critical impact on the pace with which securitizations have developed because of certain tax, banking regulation, and securities matters. The legal and regulatory environment in the United States today is quite different from the circumstances as recent as the mid-1980s, which was the major developmental period for securitizations. Specifically, in each of the three critical areas, legal and regulatory changes have been or are being made to accommodate securitizations, which underlies the view that securitization as a financing activity is relatively mature in the United States.

It is instructive to touch upon the three most important legal and regulatory changes: (i) the 1986 REMIC tax legislation permitting multitranche MBSs;[13] (ii) the treatment by the federal banking regulatory agencies for capital and regulatory accounting purposes of asset sales with recourse;[14] and (iii) the adoption by the Securities and Exchange Commission in 1992 of Rule 3a-7, providing relief for certain qualifying transactions from the Investment Company Act of 1940.[15] The legal and regulatory changes have been largely reactive: laws and regulations have changed after market participants have managed to do most (but not all) of what they wanted to do under the existing legal and regulatory framework, generally with some inefficiencies because the framework did not take account of securitizations.

Tax

Generally, for a securitization to make sense it is essential that the issuer (the trust, for example) not itself be subject to income tax (technically, under the U.S. Internal Revenue Code, that it not be treated as an association taxable as a corporation). If the issuing trust were taxed as a corporation, the trust would be deemed to have substantial taxable income. In the worst-case scenario, the income would be equivalent to the difference between the interest received on the assets, without any offsetting interest expense, as the pass-through certificates would likely be treated as equity interests instead of debt obligations on which interest is paid. Accordingly, a substantial portion of the cash flow generated by the trust's assets would be paid as taxes to the Federal Government instead of being available for distribution to investors.

In the early days of securitizations (before the 1986 REMIC legislation), a trust could be "tax passive" (that is, not give rise to income tax at the trust level) only if it issued a single class of pass-through certificates. As an exception, certificates could be issued in two classes if one class were subordinated to provide default protection to holders of the senior class and, absent defaults, received payments pro rata with the senior class. Accordingly, tax passivity and the complicated tranching and cash flow allocations that are characteristic of today's MBSs generally were not achievable.

Through the mid-1980s, the early MBSs, as well as ABSs backed by nonrevolving consumer loans (automobile receivables, for example), were grantor trusts, as described above. In terms of market efficiency, grantor trusts issuing a single class of certificates were not optimum, particularly when the underlying assets had long final maturities and would generate cash flow over an extended period. For example, if the underlying assets were 30-year mortgages, investors would receive some cash flow throughout the 30-year term of the instruments, even though the average life of the mortgages might be 12 years. Seller-sponsors, underwriters, and other market participants realized that it would be much more efficient to tranche the cash flow from the underlying assets to create multiple classes of securities when such tranching might generate more predictable cash flows (for example, by creating sequential pay classes and PACs, in which the cash flow for a particular class is paid within a narrower time band or pursuant to a specific schedule). Alternatively, the market participants could create "hedge" instruments, the value of which would respond in predictable ways to movements in interest rates (IOs and POs, for example).

The 1986 restatement of the U.S. Internal Revenue Code provided real estate mortgage securitizations (both residential and commercial) with substantially more flexibility, including, among other things, the ability to issue multiple classes of securities. The REMIC provisions added to the Code in 1986 provide tax passivity for a pool of assets that meets the requirements for a REMIC, irrespective of the form of ownership—whether partnership, corporation, trust, or some other entity—of the pool.[16] Although most REMICs are, in fact, trusts—largely because the marketplace's familiarity with trusts dates back to when MBSs were issued without REMICs—there is no requirement that the issuer be a trust. The flexibility afforded to REMICs is not available in other contexts (that is, the REMIC provisions of the Internal Revenue Code apply only to mortgage assets). The REMIC provisions allow for the issuance of multiple classes of "regular interests" (each having defined payment entitlements) and a single class of "residual interests" (which entitles investors to whatever residual cash flow is left). These provisions permit very limited substitution of assets and are available only where the underlying assets are mortgages. They give the flexibility, at least in connection with MBSs, to model the cash flow from the underlying mortgages in increasingly complex ways, thus creating increasingly complex and esoteric securities.

The major deficiency in the REMIC legislation is that it covers only mortgage securitizations. If there is a tax frontier yet to be crossed in the United States, it is to provide similar relief for nonmortgage securitizations. An industry group has been working to develop REMIC-type legislation that would cover such securitizations. Because the nonmortgage assets that have supported ABS securitizations to date have largely been shorter-term consumer receivables, there has been less pressure to resolve the market inefficiency of creating from a nonmortgage asset pool different tranches of securities for which prices and yields can be calculated based on more precisely identified segments of the yield curve.

Banking Regulations and Related Capital Treatment

Commercial banks are the largest securitizers in the United States. The regulatory accounting and related capital treatment of securitizations is critical for banks. Although a number of factors create incentives for banks to intermediate between the capital markets and borrowers by securitizing assets, one of the most important is to reduce the assets against which capital must be maintained.

The appropriate treatment for capital and regulatory reporting purposes of asset sales with recourse admittedly presents a number of problematic issues. Bankers generally would say that the current treatment is

too restrictive. However, the industry recognizes that there are no easy and definitive solutions to the banking regulatory agencies' concerns.

RAP and GAAP

An understanding of the basics of treating securitizations for capital purposes by U.S. banks is useful. As a first step, whether a purported sale will be recognized as a sale for capital purposes depends upon its treatment under so-called regulatory accounting principles (RAP), which are the accounting principles that apply to the statements of condition (call reports) filed by banks with their regulators. If a bank's purported sale of a pool of assets in a securitization is not recognized as a sale under RAP, the underlying assets will remain on the bank's balance sheet for RAP purposes (irrespective of the treatment of the transaction for purposes of generally accepted accounting principles (GAAP)). If these assets remain on the selling bank's balance sheet for purposes of its call reports, capital must be maintained against them. Consistent with the Basle Committee on Banking Supervision's 1988 Capital Accord,[17] each of the federal banking regulatory agencies' risk-based capital regulations impose an 8 percent capital requirement against risk-adjusted assets.

As to what is a sale under RAP, these principles essentially divide the world into two parts: pools of residential mortgage loans and other assets. With respect to residential mortgage loans, RAP will permit banks to treat a transaction as a sale provided that the selling bank does not retain "significant risk of loss." Significant risk of loss means, essentially, retained risk of loss (either through direct support, such as a guarantee or a letter of credit, or indirect support, through retention of a subordinate interest) that exceeds historically expected losses on the pool. (These principles are embodied in the definition of "participations in pools of residential mortgages" in the glossary to the call reports.)

The RAP treatment of sales of assets other than residential mortgages is embodied in the definition of "sales of assets" in the glossary to the call reports. For receivables other than residential mortgage loans, retention of any risk of loss from the transferred assets resulting from any cause essentially precludes sale treatment. This definition can lead to some untoward results. For example, if a bank transferred a $\$100x$ (where x is a fixed number—for example, $x = \$1{,}000{,}000$) pool of receivables to a pass-through trust in a typical securitization and provided $\$1x$ in recourse (through a $\$1x$ guarantee or a retention of a $\$1x$ subordinate interest), the transaction would be treated as a financing instead of a sale for RAP purposes, and the selling bank would have to maintain 8 percent capital (or $\$8x$) against the sold pool of receivables, even though the maximum exposure was only $\$1x$.

Regulatory accounting principles, obviously, do not follow GAAP. The basic tests for a sale under U.S. GAAP are set forth in the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 77.[18] This statement specifies three conditions needed for a transfer of receivables to be recognized as a sale:

a. The transferor surrenders control of the future economic benefits embodied in the receivables. . . .

b. The transferor's obligation under any recourse provisions can be reasonably estimated. . . . [and]

c. The transferee cannot require the transferor to repurchase the receivables except pursuant to the recourse provisions.[19]

Although there has been a great deal of discussion in the United States as to whether RAP should simply follow GAAP, the U.S. banking regulators have declined to do so, principally based on the argument—which may not be entirely correct—that GAAP emphasizes the degree to which benefits have been transferred while RAP is more properly concerned with the degree to which risks have been retained.

Excess Spread

In order to create a security attractive to investors, the process of packaging bank loans and receivables into marketable securities normally requires that the seller directly or indirectly provide some sort of credit enhancement.[20] How then can securitizations be accomplished at all with banks as sellers?

In theory, a bank could simply sell the assets underlying a securitization at a discount so that investors are effectively overcollateralized. This approach would be highly inefficient for the bank, however, because (i) the selling bank's own estimate of the amount of losses expected and, accordingly, the size of the discount are likely to be substantially less than what investors (or rating agencies, as their proxy) would require and (ii) selling at a steep discount has the consequence of creating a windfall for investors if the selling bank's expectations of anticipated losses are borne out.

The solution to date has largely been to take advantage of an off-balance-sheet contingent asset that reverts to the seller, as servicer, over time, namely, "excess spread." Excess spread is the excess of the interest rate borne by the receivables being securitized over the interest rate demanded by investors on the securities issued in the securitization, plus the customary servicing fees. Suppose, for example, that each receivable in a pool of automobile loans bears interest at 10 percent but that, in the

current interest rate environment, the marketplace for the desired rating level and the expected weighted-average maturity require that the securities issued in the securitization bear interest only at 6 percent. If the customary servicing fee to be paid to the seller-servicer is 0.25 percent, a pool of $100*x* in receivables can be sold for $100*x* in cash, and the excess spread of 3.75 percent received over time can first be applied to cover any losses on underlying receivables. To the extent that it is not necessary to cover losses (because they do not occur), the excess spread can be remitted to the servicer as "excess servicing." Provided that the seller-servicer does not treat the excess servicing as an asset (or take it into income) until it has irrevocably reverted to the seller-servicer and is no longer available to cover losses, that contingent asset may be used to enhance the credit of the securities. From a regulatory perspective, the theory is that the RAP balance sheet at all times reflects the worst-case scenario because the contingent asset inherent in excess servicing has not yet been recognized as an asset on the balance sheet. Accordingly, no asset on the call report balance sheet, which, if its value goes to zero could reduce the equity of the bank's shareholders, is at risk.

One problem with the use of excess spread to facilitate securitizations is that many assets on a bank's balance sheet do not bear interest at rates sufficiently above the interest rates demanded by the capital markets to create an excess spread sufficient to enhance the credit of a securitization. Arguably, this constraint has hampered some securitizations, for example, of commercial and industrial loans. However, the major constraint is the lack of homogeneity—as well as the predictability—of losses and payment streams.

Notice of Proposed Rulemaking

In these circumstances, the federal banking regulatory agencies, acting through an interagency council known as the Federal Financial Institutions Examination Council, have proposed far-reaching changes in the current rules (some good and some bad, from the industry's perspective).[21] One set of proposals, included in a Notice of Proposed Rulemaking that has been made public by the Federal Reserve and the Federal Deposit Insurance Corporation, would require credit enhancers (in the same manner as sellers providing recourse) to maintain capital against the entire asset pool undergoing credit enhancement instead of against only the amount of the credit enhancement.[22]

The regulations described above, under which a purported sale would be recharacterized as a financing, apply only to sellers. They do not apply to third-party credit enhancers. Instead, a credit enhancer writing a letter of credit or funding a cash collateral account to support some other

bank's securitization is required under the existing rules to maintain capital only against the amount of its credit enhancement. The proposed change would implement the regulator's principal of "equal capital for equal risk." That is, if credit could be enhanced for a $100*x* pool of assets underlying a securitization by either a $6*x* subordinate interest retained by a seller or a $6*x* letter of credit provided by another bank, the amount of capital required by the seller on the transaction (if the first alternative were chosen) or the unaffiliated credit enhancer (if the second alternative were chosen) should be the same. Under the existing system, the credit enhancer has to maintain 8 percent capital against $6*x*, or $.48 in capital; under the Notice of Proposed Rulemaking, the credit enhancer (like a seller) would be required to maintain 8 percent capital against the entire $100*x* pool, or $8 in capital. Both sellers and credit enhancers would be subject to a capital charge capped at the amount of the recourse.

Advance Notice of Proposed Rulemaking

An Advance Notice of Proposed Rulemaking was published on this matter in 1994.[23] It implements a ratings-based, multilevel approach, under which a bank's risk-based capital charge for certain asset securitizations would depend on its relative risk of loss.[24] Although credit enhancers view the equal capital for equal risk principle embodied in the Notice of Proposed Rulemaking as anathema, the Advance Notice of Proposed Rulemaking would provide some relief. Industry participants commenting on the Advance Notice of Proposed Rulemaking strongly argue that the portion of the Advance Notice of Proposed Rulemaking addressing credit enhancers should be implemented only if relief for qualifying transactions is simultaneously provided for in the Advance Notice of Proposed Rulemaking.

The Advance Notice of Proposed Rulemaking is based upon a hypothetical, simplified transaction that assumes (i) a senior, highly rated security; (ii) a "middle-level," subordinated security or interest that is in a second-dollar loss position and enhances the credit of the senior security; and (iii) a subordinated security in a first-dollar loss position that enhances the credit of the two more senior tranches.

The Advance Notice of Proposed Rulemaking would make three provisions. First, if a middle-level, subordinated security or a second-dollar loss enhancement (whether in the form of recourse or a direct credit substitute) is rated at least investment grade by a nationally recognized statistical rating agency, the seller providing recourse or the third-party providing the direct credit substitute by writing or holding such position would be assessed capital only against the face amount of the recourse or credit enhancement. Second-dollar loss positions that do not qualify for

this approach (including purchased subordinated securities and letters or credit) would be charged capital, based on the bank's exposure and the more senior portions of the pool.

Second, the Advance Notice of Proposed Rulemaking would provide that the most senior class of a qualifying securitization transaction would be risk weighted at 20 percent (regardless of the underlying asset type) if this class received the highest credit rating from the same rating agency that rated the second-dollar loss position. However, senior positions that are supported by prior credit enhancements carrying third-party performance risk (for example, standby letters of credit) would not qualify for this treatment.

Third, with respect to recourse arrangements or direct credit substitutes in a first-dollar loss position, the low-level recourse rule (capping the capital charge at the amount of the recourse) included in the Notice of Proposed Rulemaking would apply. That is, capital would be charged dollar-for-dollar against the bank's exposure up to the full risk-based capital charge for the assets.

Rule 3a-7 Under the Investment Company Act

The Investment Company Act[25] provides a comprehensive regulatory scheme for managed investment funds. Although the perceived need to regulate managed investment funds gave rise to the enactment of the statute in 1940, its actual reach is much broader. The Investment Company Act by its terms imposes its regulatory scheme on any entity whose assets are primarily "investment securities."[26] Accordingly, for purposes of the statute, almost any obligation to pay (including all kinds of bank loans) is an investment security, with limited exceptions made for government securities and stock of operating subsidiaries. Therefore, most trusts and other securitization vehicles, absent an exemption, are by definition "investment companies." The Investment Company Act imposes a series of substantive restrictions on investment companies (including with respect to capital structure and dealings with affiliates) that would make it impossible to conduct the normal securitization of assets as a registered investment company.

The Investment Company Act has included since its adoption exceptions from investment company status for companies that are primarily engaged, among other things, in (i) purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; and (ii) purchasing or otherwise acquiring mortgages and other liens on, and interest in, real estate.[27] Subject to sometimes arcane

interpretations by the staff of the Securities and Exchange Commission as to the availability of these exemptions, most securitization vehicles for the assets traditionally securitized in great volume (residential mortgage loans and various kinds of consumer receivables) have been able to rely on one or another of these exemptions.

In 1992, however, the Securities and Exchange Commission adopted a new rule, Rule 3a-7,[28] intended to permit, subject to the rule's specific requirements, securitizations free of regulation under the Investment Company Act, irrespective of the type of loan or receivable being securitized (including any collateral for, or the use of proceeds of, the loan or receivable). Rule 3a-7 exempts from status as an investment company a vehicle in which the assets are (i) "eligible" financial assets that by their terms convert into cash within finite time periods and (ii) "fixed-income" securities issued to public investors that have stated interest or principal amounts, or both, and are rated in one of the four highest categories by at least one nationally recognized statistical rating organization.[29] (The foregoing describes only the essence of the rule, which includes a number of other detailed requirements.)

Rule 3a-7 reflects a major regulatory step by the Securities and Exchange Commission to remove an artificial limitation on securitizations. At the margin, Rule 3a-7 will make a difference because it will permit securitization of a variety of receivables that would not otherwise have fit under the existing exemptions. However, it is not likely to contribute to a fundamental growth or change in direction in the U.S. securitization market (particularly where banks are the seller-sponsors) because the types of assets that most lend themselves to securitizations, given their characteristics, could be fit within the existing exemptions, as described above.

Risk

The track record for securitizations in the United States is remarkably good for investors and seller-sponsors. Apparently, a rated public securitization with a commercial bank as seller-sponsor has never gotten into trouble or incurred a loss for its public investors.

The analysis of risk for commercial bank seller-sponsors must be a bit more subtle because, as described above, they are constrained in providing credit enhancement but allowed to treat transactions as sales for regulatory accounting and capital purposes. The federal banking regulatory agencies, through the examination process, look very closely at the exposure of banks that are major securitizers. These agencies focus primarily on three areas. First, in light of the overall securitization activities

of a particular bank, has that bank sold its better assets and retained its weaker assets ("adverse selection," insofar as the bank is concerned)? Second, does a bank have an incentive to lower its loan underwriting criteria for asset types that it securitizes in order to generate assets to support its securitizations (and, in turn, generate fee income)? Third, does a bank that acts as a seller-sponsor, irrespective of its contractual obligations, feel compelled to provide "moral recourse" (that is, to reimburse investors for losses even when it is not contractually obligated to do so), in order to support the market for its future securitizations?

The concerns cited above are appropriate focal points for bank examiners. Each of the federal banking regulatory agencies is well attuned to these risks and has developed specific guidelines to assist its examiners in their evaluation. However, there has not apparently been a case in which a bank has been deemed to raise supervisory concerns as a result of its securitization activities.

Conclusion

Securitization, as a process of intermediating between capital markets and borrowers (largely individuals), has been a great success in the United States. It has contributed significantly to the availability of consumer credit at attractive rates while enabling banks and other financial institutions (which, absent securitization, would themselves be funding these loans) to pass a variety of risks on to the marketplace.

As is almost inevitable when new frontiers are being probed, changes in the U.S. legal and regulatory framework concerning securitizations have largely been reactive. This is certainly true of (i) the REMIC tax legislation,[30] which permits substantially greater flexibility for multitranche MBSs than the old-style, sequential-pay collateralized mortgage obligations (CMOs) issued by owner trusts; (ii) the "with recourse" bank capital proposals currently being considered by the federal banking regulatory agencies;[31] and (iii) the adoption by the Securities and Exchange Commission of a structured finance rule (Rule 3a-7), which provides an exemption from the Investment Company Act for qualifying transactions.[32]

Securitization in the United States is a relatively mature activity that has reached a plateau. In other words, those kinds of assets that represent a material portion of financial institutions' balance sheets and are likely candidates for securitization (given their homogeneity and other terms) are already being securitized in a significant way.

The principal developments in securitization in the United States over the next couple of years will principally be around the edges, that is, the changes will increase the efficiency of transactions that are already occurring. These developments may include tax legislation permitting REMIC-like flexibility for non-MBS ABSs, as well as more favorable capital treatment for bank investors in MBSs, along the lines proposed in the Advance Notice of Proposed Rulemaking under consideration by the federal banking regulatory agencies.

COMMENT

SANDRA M. ROCKS

Securitization, of course, predates computer technology. One could say that nonrecourse financing techniques—such as the sale of participations in loans and the factoring of accounts—are early forms of "securitization." These types of transactions, which admittedly do not always achieve the objective of protecting purchasers from sellers' insolvencies, have been conducted for many years. One of the burdens faced by participants in the more modern U.S. securitization process and one that will be a theme in nearly every other jurisdiction in which this type of securitization is implemented is that the analysis of these modern transactions is based on precedent, if any, that addressed the more primitive type. In the system based on common law, a sedimentary buildup of case law addressing financing techniques of the adding machine age is being used for guidance in the computer age. The cases do not address anything nearly as sophisticated as what the new securitization transactions have created. (In civil law jurisdictions, the problem may even be worse as, in some countries with such a tradition, it is unlikely that statutes addressing these concerns have been written.)

Insolvency Risks

Some understanding of U.S. law issues is helpful in thinking about international securitization. This thinking by analogy becomes very obvious when it comes to one of the underlying premises of securitization: "insulation." One of the primary objectives of participants in this area is to insulate the assets supporting the securitization from any adverse consequences that might flow from the seller's insolvency. Rating agencies, referred to by some as "gatekeepers," and sophisticated investors alike are well versed in the risks associated with insolvency proceedings under U.S. law and have developed structures and credit-enhancement features to mitigate these risks and ensure that the investors' interest in the assets will not be affected adversely by a deterioration in the seller's financial condition.

The question that may come to mind at this point is, How does one know whether the assets need insulation? In the United States, several aspects of insolvency law can create delay, lead to the termination of contractual relationships, or even result in disregarding the investors' interest and the recapturing of assets (including cash flow) by the bankruptcy

trustee, all of which would present barriers to a successful securitization. With respect to international securitizations, the gatekeepers typically ask whether these risks are present; they expect to be told not only about the risks of which they have become aware under U.S. law, but also about anything else that should concern them. The following is a brief description of the major U.S. insolvency risks.

Automatic Stay

The commencement of a bankruptcy proceeding under the U.S. Bankruptcy Code operates as an automatic prohibition against the taking of action against the debtor or against property owned or controlled by it.[1] Thus, if the issuer of the securities became subject to a bankruptcy proceeding, investors could not gain access to the underlying assets, and the cash flow would be held up until bankruptcy court approval for continued payments could be obtained. Termination of the seller's role as servicer would also be prevented. The need for such approval would, at the very least, entail temporary delay and under certain circumstances might not be obtainable until the bankruptcy proceeding was concluded.

Avoidance Power

A bankruptcy trustee has the power to "avoid"—that is, to set aside—unperfected interests in the debtor's property (often referred to as the "strong-arm" power) and to avoid perfected interests that are considered to constitute "preferential transfers" or "fraudulent conveyances."[2]

Strong-Arm Power

Under U.S. law, most interests of investors in securitizations can be perfected without undue effort or expense. Interests in receivables, for example, can be perfected by a fairly simple filing in one jurisdiction. Interests in securities and other instruments can be perfected by delivery or another method of transfer to the trustee acting on behalf of security holders. Interests in mortgage loans typically require delivery of the mortgage notes and recordation of assignments of mortgages to the trustee (recordation does, in a few jurisdictions, require payment of a recording tax).

One type of securitization in which all steps necessary to perfect the investors' interests are sometimes not taken is the securitization of automobile receivables. The need in some cases to make a notation of the trustee's interest on the certificate of title has been thought to be too cumbersome, given the number of automobiles involved and the effects

of local (state) variation in these requirements. Moreover, the payment obligation of the automobile purchaser or lessee is considered the primary source of payment to investor; foreclosure on the automobile itself would be troublesome and possibly costly.

In the vast majority of cases, however, U.S. law provides a relatively painless and inexpensive method of ensuring that the investors' interests will have priority over competing claimants and will be respected in the event of an insolvency proceeding. This legal situation may constitute another factor that has given the United States a head start in the securitization business.

Preferential Transfers

Under the U.S. Bankruptcy Code, the trustee can avoid interests created in favor of lenders to, and purchasers from, the debtor if (i) the interest conveyed were "on account of an antecedent debt"; (ii) the transfer occurred within the "preference period" (generally 90 days before the bankruptcy proceeding, but one year before if the transfer were to an "insider," including an affiliate); and (iii) it enabled the transferee to receive more than would have been received if the debtor were liquidated.[3] This description of preferential transfers avoids many technical issues and other nuances that may or may not be significant in any particular deal. Several exceptions to this avoidance power exist, most notably for transfers in which the debtor contemporaneously receives "new value" for the interest conveyed.[4] This would occur if the assets were purchased for cash but not if the assets were conveyed to meet collateralization requirements. (Thus, additions of collateral would not be available until they were "seasoned," that is, until the expiration of the preference period following the transfer.)

Fraudulent Conveyances

A related concern under the U.S. Bankruptcy Code is the trustee's power to avoid transfers of property (and incurrence of debt) when the debtor is insolvent and receives less than "reasonably equivalent value" in exchange.[5] In contrast to the preference provisions, transfers of collateral to secure existing indebtedness are not avoidable because antecedent debt constitutes "value" under the fraudulent conveyance provisions. Sales of assets would also be immune from avoidance as a fraudulent conveyance as long as the purchaser paid "reasonably equivalent value" for them.

Recapture

The result of any avoidance of preferential transfers or fraudulent conveyances is an ability on the part of the bankruptcy trustee to recapture the assets or their value from the immediate or subsequent transferees (with certain limited exceptions). Thus, the value of cash flow received or additional collateral posted within the preference period or the applicable limitations period for fraudulent conveyances (one year under the Bankruptcy Code[6] and up to six years under relevant state law) could be required to be returned. The presence of serious risk on this front would obviously make the securitization unworkable.

Not surprisingly, investors worry—and the rating agencies assume—that the originator-seller of the assets will become insolvent and that one or more of the foregoing principles will be applied to disrupt payments to investors (temporarily or permanently). Consequently, a fairly common structure has been developed in the United States involving a "true sale" to a separate, "bankruptcy-remote" entity (which investors and the rating agencies assume will not become insolvent), in order to insulate investors from these risks.

Establishment of Bankruptcy-Remote Issuer

Use of such special-purpose vehicles as bankruptcy-remote issuers has been a part of securitization almost since the beginning. Typically, a new corporation, partnership, or business trust is created under organizational documents that restrict the activities of the entity to those necessary to the securitization, most notably acquiring and caring for the assets and dealing with the cash flows. Other indebtedness is typically prohibited.

In addition to limiting the activities of the entity to prevent a direct bankruptcy filing, other steps are taken to ensure that the entity will be respected as a separate entity, notwithstanding the bankruptcy of its affiliates. U.S. bankruptcy trustees have the equitable power to order the "substantive consolidation" of the assets and liabilities of more than one entity. This power has typically been exercised when affiliates conduct themselves in a manner that shows disregard for their own separateness and is misleading to creditors.

Accordingly, in order to make it unlikely that the new entity will be substantively consolidated with its affiliates (whose bankruptcy is not "remote"), a number of actions are frequently taken. First, a separate office can be established for the new entity. Second, the new entity can be required to observe the necessary corporate formalities and to have at least one officer and director that is "independent" from all affiliates.

Third, the entity can be prohibited from dealing with affiliates on other than arm's-length terms, and generally prohibited from giving or receiving guarantees to or from affiliates. Fourth, the entity can be prohibited from having its assets commingled with those of, or otherwise held by, affiliates. Fifth, separate (typically audited) financial statements can be produced. Finally, the new entity can be "held out" as separate from the affiliates and its assets made unavailable to creditors of those affiliates.

When partnerships, rather than corporations, are used as the new entity, the general partner must ordinarily qualify as a bankruptcy-remote entity itself (meeting the criteria just mentioned). Obviously, when a business trust is used, a certain amount of adjustment must be made to satisfy these criteria—in spirit, if not in letter.

Absolute Conveyance of Assets to Special-Purpose Vehicle

The establishment of a separate, bankruptcy-remote entity does not of itself result in the requisite insulation. Once the appropriate type of entity is established, the assets to be securitized must be conveyed to that entity in such a way that they will not—for reasons other than "substantive consolidation"—be considered or become part of the seller's property in the event of the seller's insolvency. The assets must, therefore, have been "truly sold," rather than pledged, to the new entity. If they have merely been pledged, they will remain property of the seller's estate, and the automatic stay provision would prevent the special-purpose vehicle or anyone acting on behalf of investors from exercising control over the assets without court approval, as discussed above. There is some difference of opinion among U.S. law firms on the factors that would provide a basis for "recharacterizing" a sale as a secured borrowing. It is fair to say, in general, that the presence of direct or indirect recourse against the seller is often at the center of this debate.

In addition, the initial and any subsequent conveyances must not be avoidable as preferential transfers or fraudulent conveyances. For this reason, the seller cannot be obligated to convey additional assets except for "new" and "reasonably equivalent" value. In many securitizations, the initial conveyance of assets involves both a purchase by the new entity—using the proceeds of the securitization—and a capital contribution by the seller (assuming, as is usually the case, that the seller is the parent). Normally, capital is contributed to give the new entity sufficient "excess coverage" to make the securitization viable from the point of view of investors and rating agencies.

Financial guaranty insurance is also used fairly commonly in U.S. securitizations. Such insurance can be used to protect investors with respect

to debt and pass-throughs, as the highly rated insurer takes the risk that the seller's insolvency will prevent full and timely access to the underlying assets. These insurers are typically risk averse (and have their own ratings to keep) and, therefore, seek comfort on the very issues that would otherwise concern rating agencies and investors.

The law remains unsettled concerning the claims that holders of securitization may bring against the institution responsible for the securitization. Assuming that the holders of the securitized claims retain some residual claim against the bank that managed the securitization, the issue arises whether, in the event of the bank's insolvency, its receiver has the power to stay and avoid claims that the holders of the securitization may have against the bank. State banks governed by state law in this regard may be subject to different rules. National bank insolvencies are governed by the National Bank Act[7] in the first instance but become subject to the provisions of the Federal Deposit Insurance Corporation Act[8] (insofar as the law requires the Federal Deposit Insurance Corporation to be appointed as the receiver of such banks if they are declared insolvent by the Office of the Comptroller of the Currency; the Federal Deposit Insurance Corporation may also become the receiver for state-chartered banks). Insurance companies are governed by the laws of the states in which they are chartered, and it is to these laws that reference must be made on these issues if an insurance company is responsible for the securitization.

International Structured Finance

International structured finance has been examined elsewhere.[9] One of the earliest securitizations originated in Latin America (namely, the securitization of the receivables of Mexico's national telephone company from AT&T). Bancomer has securitized certain MasterCard and Visa credit card receivables, and Mexico's national petroleum company has securitized its oil receivables. In addition, the securitizations of various Mexican toll roads have been successfully marketed.

A certain impetus toward securitization in the international arena, as well as in the United States, has been generated by the Basle Capital Accord.[10] In fact, some commentators expected even more of a surge in international securitization after it came into effect, but the path to securitization outside the United States has not been without stumbling blocks. For instance, to the extent that hedging against interest rate and currency risk is involved, the counterparties must be sufficiently creditworthy for investor and rating agency confidence. Sovereign risk may also come into play. More fundamental, however, is the need to analyze asset

and seller risks under the laws of the relevant jurisdictions. The U.S. law analysis set forth above is a starting point in many cases, and it certainly informs the thinking of the rating agencies worldwide. The initial questions posed by rating agencies and investors often focus on whether the U.S. legal risks are present in the country in question. Sometimes, even the disclosure included in international securitizations reads very much like that included in U.S.-based transactions.

As briefly noted, the steps required to insure that the investors' interests are insulated from claims of other creditors of the seller are often more cumbersome in other jurisdictions. In some countries, for example, the account debtor must apparently be notified for receivables to be sold. Failure to do so renders the investors' interest at most one of an "equitable" nature, easily displaced by subsequent claimants. This has been the case in Japan, although the Ministry of International Trade and Industry has been instrumental in passing a new statute to create a public notice system for perfection without notification of account debtors.[11] Wholly aside from the practical burden imposed by a notification system, an issue of psychology has historically generated resistance to the securitization of receivables in Japan, where the selling of a customer relationship has been viewed as an act of desperation by a failing company. Such a situation would, of course, not bode well for collecting on existing receivables, let alone generating new ones.

Worse, perhaps, than the burdensomeness of the steps required to be taken in some jurisdictions is the lack of certainty as to how the conveyance of the assets can be legally accomplished at all. However, the combination of pressures favoring securitization and the investment appetite for the products that securitization produces will continue to create an incentive for finding or creating greater certainty in an ever-increasing number of jurisdictions.

Chapter

25 Payment Systems

25A. Legal Issues Regarding Payment and Netting Systems

MARIO GIOVANOLI[1]

The Concept of Netting

In recent years, netting has attracted much attention in the financial world. This seems at first sight quite surprising, as the concept and the underlying factual situation are by no means new. Netting, which has no precise legal definition, has been described as

> an agreed offsetting of positions or obligations by trading partners or participants in a system. The netting reduces a large number of individual positions or obligations to a smaller number of positions. Netting may take several forms which have varying degrees of legal enforceability in the event of default of one of the parties.[2]

Interest in netting schemes and arrangements has recently been focused on two areas of financial operations: payment systems and contractual commitments—mainly in connection with derivatives and foreign exchange transactions. In the field of payments, bilateral or multilateral netting schemes can, if properly managed and enforceable in law, ensure a significant saving of routine liquidity and contribute to risk reduction; however, following technological developments, real-time gross settlement (RTGS) systems are now considered by many to be more appropriate for large-value payments. In the field of contractual commitments, especially in connection with derivatives, where netting is essentially bilateral, a netting arrangement allows parties to reduce own funds requirements, to the extent that these arrangements are enforceable in all relevant jurisdictions and recognized by the relevant supervisory authorities.

The main purpose of this chapter is to give a general overview of the legal issues raised by payment and netting systems, particularly from an international perspective. It does not attempt to provide an in-depth analysis of specific questions, which have to be studied on the basis of the national law or laws applicable in each case.

Origin and Scope of Netting in Payment Systems

Predominance of Cashless over Cash Payments

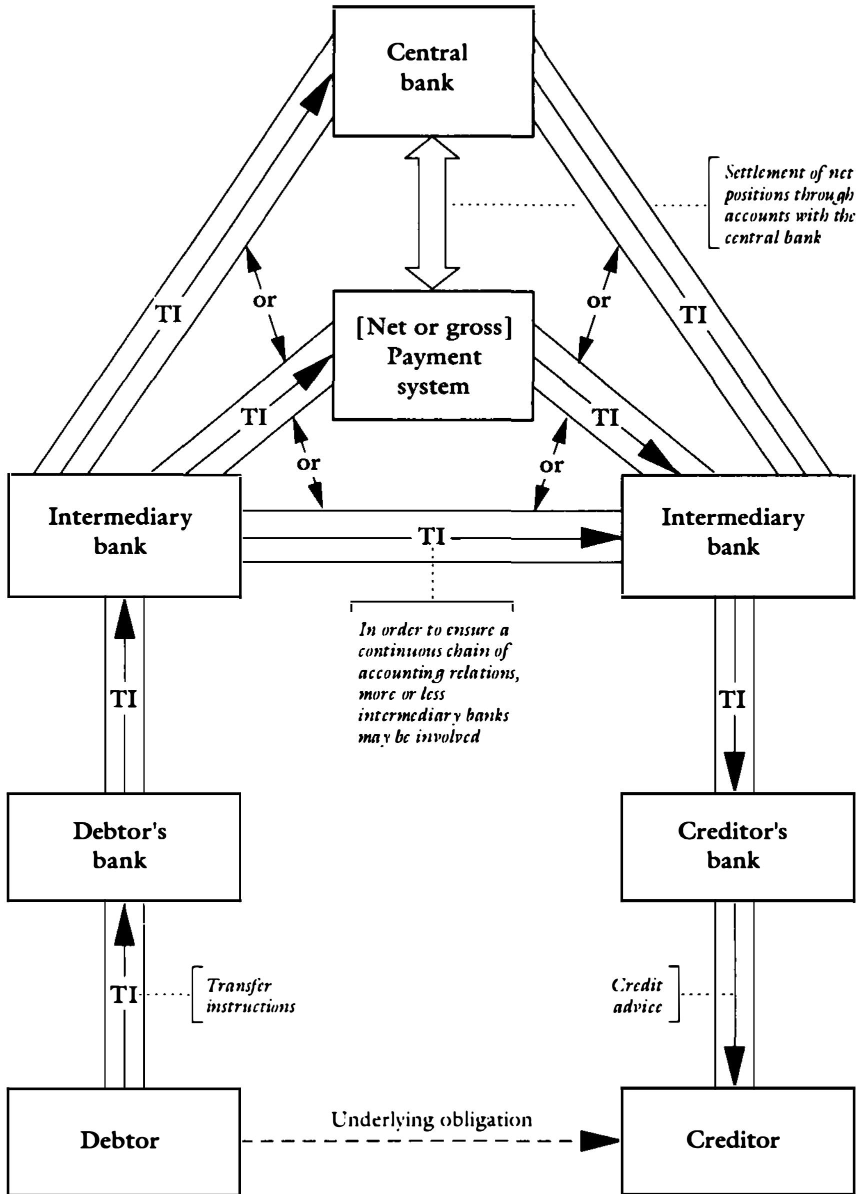
In modern, developed societies, the bulk of the monetary assets available for discharging monetary obligations is composed of liquid deposits in the banking system,[3] rather than coins and banknotes. Legally speaking, these assets are claims against the depositary banks and thus subject to the individual credit (insolvency) risk of the depositary banks concerned, save for balances held at the central bank, which are as risk free as banknotes issued by that central bank.[4] This chapter does not examine the legal concept of money[5] or the circumstances in which monetary obligations may be—and sometimes even have to be—discharged by cashless "payments" in the banking system, rather than in banknotes and coins issued by the central bank or by an official mint and that are legal tender.[6] In the modern, cashless society, despite differences in the payment practices of various countries,[7] cashless payments represent the vast majority of payments in value and sometimes even in number. Consequently, the expression "payment" is not used here in its traditional meaning of cash payment (that is, the transfer of possession and ownership of coins or banknotes, or both), but to describe cashless payment[8] or credit transfer.[9]

Payment Transactions and Payment Systems

Except for in-house transfers, a single payment transaction involves two or more banks (see Figure 1),[10] and, in the case of credit transfers in foreign currencies, the settlement is normally effected through correspondent banks in the country of the currency concerned (the so-called U-turn in the country of the currency, which is illustrated in Figure 2). In any event, for the completion of the payment process, it is essential to use channels made up of a continuous chain of account relationships,[11] in which each account relationship may be governed by a different substantive law and subject to a different jurisdiction, as well as to specific contractual arrangements. The chain of account relationships through which a credit transfer is channeled[12] must be carefully distinguished from the underlying obligation between the originator and the beneficiary of the payment:[13] the underlying obligation may well be subject to a different governing law, and the forum for resolving any dispute may also be different.[14]

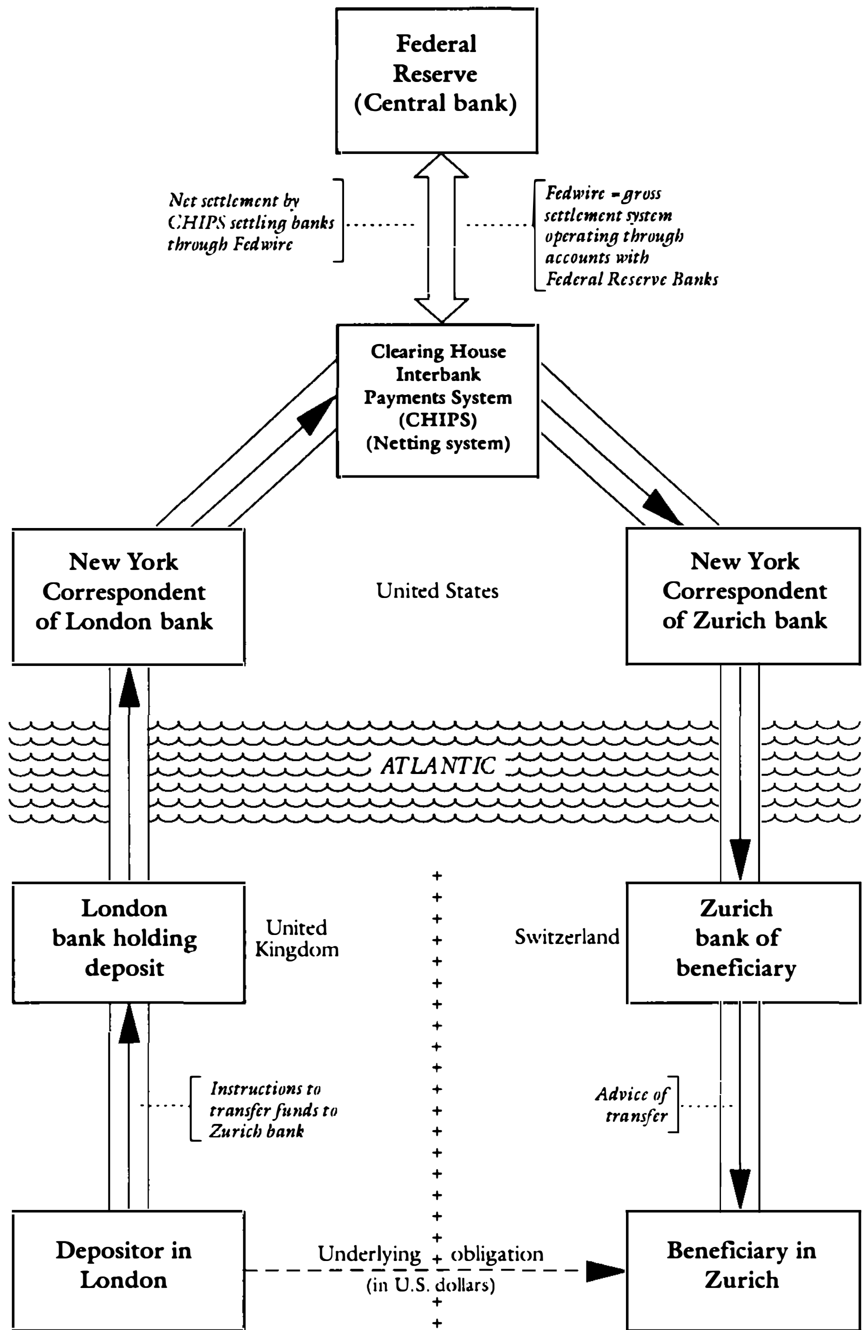
In parallel with the impressive growth of credit transfers, the related payment procedures in the banking systems of most countries have

Figure 1. Payment by Credit Transfer: Chain of Transfers



Note: TI = Transfer instructions.
Accounts of debtor and creditor are with different banks that have no direct account relationship. If the debtor's bank and the creditor's bank have a direct account relationship or have direct access to a payment system, the chain of transfers may be shorter, as no intermediary banks are involved.

Figure 2. International Credit Transfers: The "U-Turn" in Eurodollars



evolved into more or less institutionalized payment systems, with specific operating, regulatory, financial, and legal arrangements. The development of these payment systems, some of which—in particular multilateral net payment systems—already existed as early as the Middle Ages,[15] has been considerably stimulated in recent decades by the explosion in financial activities, the globalization of financial markets, and the introduction of information and telecommunications technology.[16] The structure,[17] characteristics, and legal basis of payment systems vary widely.

Origin of Payments Netting

Netting[18] is not a recent phenomenon. Bilateral netting, which largely but not exclusively relies on the well-known legal mechanism of setoff, was certainly known in Roman law and perhaps even by the Babylonians, who apparently practiced the current account technique. Multilateral netting appeared in the late Middle Ages and was used in the thirteenth century at the trade fairs in the French region of Champagne. To alleviate the lack or relative scarcity of cash, merchants used to meet during the last days of the fair, first, to set off their mutual claims bilaterally, thus obtaining a net position, and second, under the supervision of the merchants' provost, to calculate their multilateral "net-net" position. Each merchant had to announce that position to the provost, who then checked the accuracy and consistency of the underlying calculations by adding all the net-net positions, which should produce a zero result. Finally, these net-net balances were settled, either in cash or by drawing bills of exchange. Such multilateral netting and settlement arrangements, known under the names "skontration" or "riscontro," were widely practiced at trade fairs and financial centers in France, Germany, and Italy in the following centuries.[19] The first known statutory regulations applicable to multilateral netting seem to date from 1597 and were drafted in the (now French) city of Besançon. These early examples of multilateral netting have some features that are well-known to the lawyer of today: for instance, in some places merchants wishing to participate in the netting scheme had to provide collateral before being admitted to do so.[20]

About 1775, the modern tradition of clearing started when the clerks of the main London City banks, rather than making many trips every day to all the other banks, decided to meet daily in the backroom of a coffee house on Lombard Street, with a view to clearing more conveniently the checks drawn on their respective banks.[21] The advantages of this practice were rapidly recognized by the banks, which arranged to rent for this purpose a "clearing room" in Lombard Street. From 1864, when the settlement of the net-net positions in cash was replaced by credit transfers through accounts held by the clearing banks with the Bank of England,

the clearinghouse took its modern form as a national clearing system.[22] The Lombard Street clearinghouse quickly became the model for similar institutions elsewhere in England, the United States (where the New York clearinghouse was established in 1853), and various European countries. The scheme was also adapted for other types of transactions, including forward transactions on commodities, such as cotton.[23] Later, the range of applications of netting schemes was extended to include swap transactions and futures, as well as book-entry securities. The infrastructure has now been taken over by sophisticated computer technology that makes it possible to process a huge volume of transactions at great speed, but the new technology has not significantly altered the fundamental features of netting.

Central Banks' and Supervisors' Concerns About Payment Systems

Although the actual degree of involvement of central banks in the operation of payment systems varies considerably from country to country, there is a wide consensus that there is a need for central banks to oversee payment systems in order to ensure their smooth and efficient functioning, as well as their integrity and stability. Many laws on central banks expressly mention, among other essential functions, the central banks' role regarding payment systems, which is linked to the task of providing sufficient liquidity to the banking system, particularly in cases of emergency. This is the central bank's lender-of-last-resort function. Most interbank payments are ultimately settled over accounts in central bank books,[24] either individually, in gross settlement systems, or in aggregate net amounts, in net payment systems. In any case, most of the monetary aggregates monitored by the central banks in implementing monetary policy are based on credit balances within the banking system. It follows naturally that, to a large extent, "[a] country's payment system is the channel through which the central bank passes on its monetary policy."[25]

Whether such functions are concentrated in the central bank or vested in separate authorities, regulators and supervisors of the banking system (and, more generally, of the whole financial system) are concerned with potential risks in connection with payment systems.[26] As the discharge of monetary obligations of any origin (whether resulting from commercial or financial transactions) relies heavily on the smooth functioning and efficiency of payment systems, any disruption or dysfunction may have highly detrimental consequences for the economy as a whole. Moreover, payment systems could, if poorly managed, propagate financial disturbances and possibly even amplify such disturbances by inducing chain reactions through the "domino effect" that might, in a worst-case scenario, contaminate the whole financial system (so-called systemic risks).

While, under the capital standards presently in force for credit institutions, there appear to be no capital requirements *directly* related to risks arising from payment systems, such requirements may arise *indirectly*, especially in connection with certain risk-reduction schemes comprising liquidity facilities or loss-sharing formulas.

The allocation of supervisory responsibilities with regard to cross-border payment schemes gives rise to particular problems. The main concerns in this area are establishing which single supervisory authority has the primary responsibility for overseeing the system as a whole, determining where the responsibility for settlements in domestic currency lies, and ensuring satisfactory cooperation among the various supervisory authorities concerned.[27]

Types of Payment and Settlement Systems

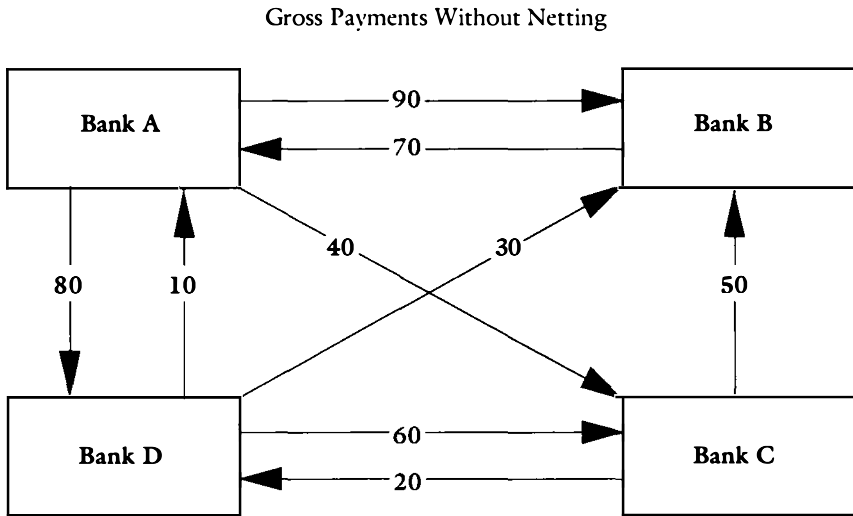
Gross Settlement Systems

There are fundamentally two types of payment and settlement systems: gross settlement systems and net settlement systems.[28]

The structure of gross settlement systems (see Figure 3, top panel) is relatively simple, as each individual payment is processed separately and (unless explicit credit is granted within the system) effected as soon as cover is available on the account of the clearing bank. Thus, the settlement does not rely on any setoff mechanism between participants (except in connection with the normal operation of bank accounts) or on any intraday credit implicitly granted by other participants in the system. Furthermore, each settlement is final,[29] and there is no unwinding mechanism: modern information technology has practically eliminated any time lag between the entry of the transfer order and the settlement, putting into place RTGS systems. Queuing arrangements (usually on the principle of "first in, first out") are normally provided for in situations where neither cover nor explicit credit is available for payment orders. However, gross settlement systems do not present the advantages of conserving explicit routine liquidity and reducing the number of settlement operations. In addition, if certain banks delay the entry of orders for transfers or are unable to effect them as expected (because they are themselves expecting first to receive payments from other participants in order to have the required cover), gridlock may result unless appropriate liquidity facilities are available.[30]

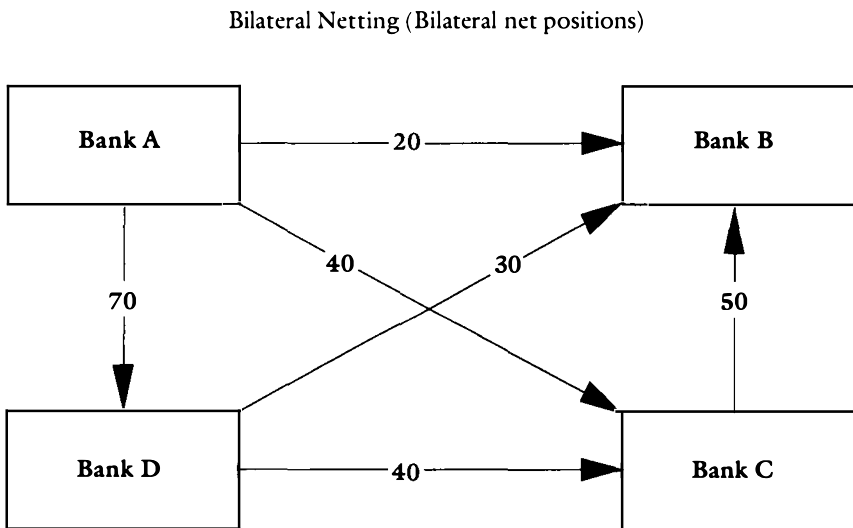
Figure 3. Gross Payment Systems and Bilateral Netting

Gross Payments Without Netting



Note: Number of payments = 9; total volume of payments = 450.

Bilateral Netting (Bilateral net positions)



Note: Number of payments = 6; total volume of payments = 250.

Net Settlement Systems

Net settlement systems are much more complicated with respect to their basic legal structure. In a multilateral net settlement system, the payment process[31] can typically be divided into two phases: netting (Figure 4)[32] and settlement (Figure 5). During the netting phase, the various payment orders given by the participating clearing banks in favor of other participants (or for their customers) are transmitted to a netting agent, who calculates the net overall position (credit, debit, or nil) of each participant at an agreed cutoff time. Unless special contractual arrangements provide for novation (or other mechanisms with a comparable effect), such net positions are usually not considered to be legally binding in themselves, as they are merely the result of an accounting exercise ("advisory or position netting"). During the second phase, participants with net debit positions must effect settlements in favor of participants with net credit positions.

Once all settlements have been effected in the system, the individual payment orders[33] included in the netting process of the day are deemed to be carried out.[34] If any participant were unable to settle its net debit position at the end of the day, the typical solution would be to unwind that day's netting, which could then be repeated after excluding the defaulting participant.[35]

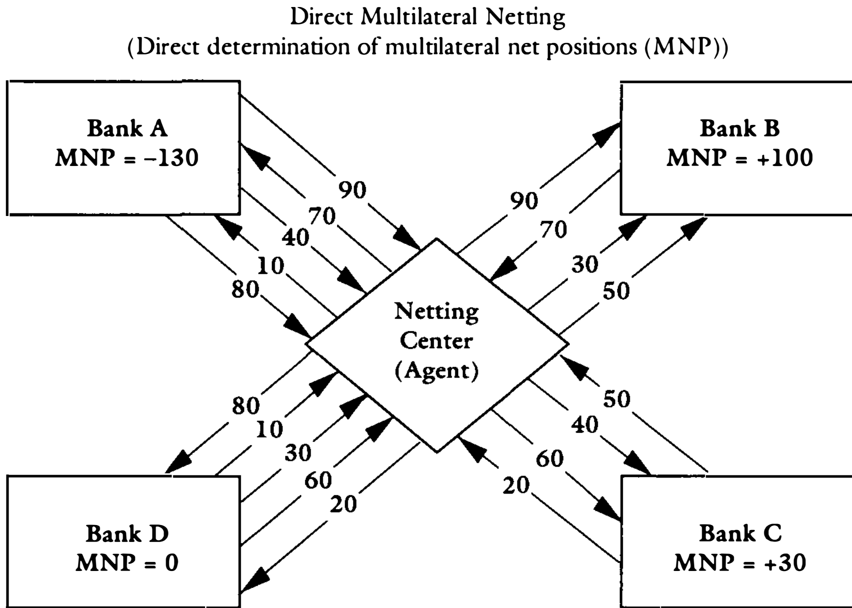
The main advantages of net payment systems are a substantial reduction in the number and value of interbank settlement operations and the consequent significant conservation of explicit routine liquidity, which can be estimated at an average of some 80 percent in multilateral payment systems.[36] Furthermore, provided that the final settlements are completed, the liquidity risk (and arguably the credit risk) involved in payment systems, as well as the exposure to settlement risks arising from foreign exchange ("Herstatt risk") or securities transactions, can be considerably reduced. However, unless appropriate safeguards are applied, multilateral net payment schemes carry the risk that participants rely on their anticipated net positions, although these positions are usually not legally binding and remain subject to the successful settlement of the net positions of all participants at the end of the day. In other words, during the time lag between the netting phase and the final settlement, participants with net credit positions effectively grant implicit credit to participants with net debit positions.

Netting of Contractual Commitments

The expression "netting," which has recently become widely used, has no precise or single meaning in law. Therefore, different factual and legal

Figure 4. Multilateral Netting: Netting Phase with Direct and Indirect Multilateral Netting

Direct Multilateral Netting
(Direct determination of multilateral net positions (MNP))



Indirect Multilateral Netting
(Determination of "net-net" positions (NNP) by netting the net bilateral positions)

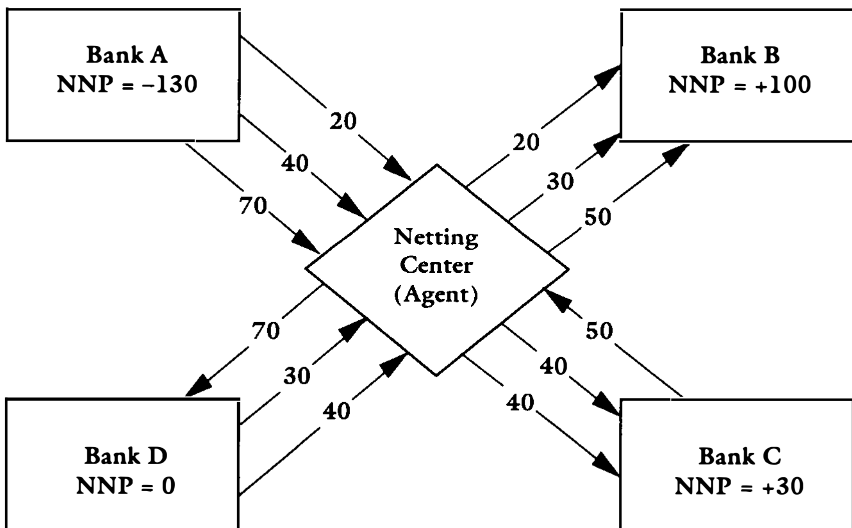
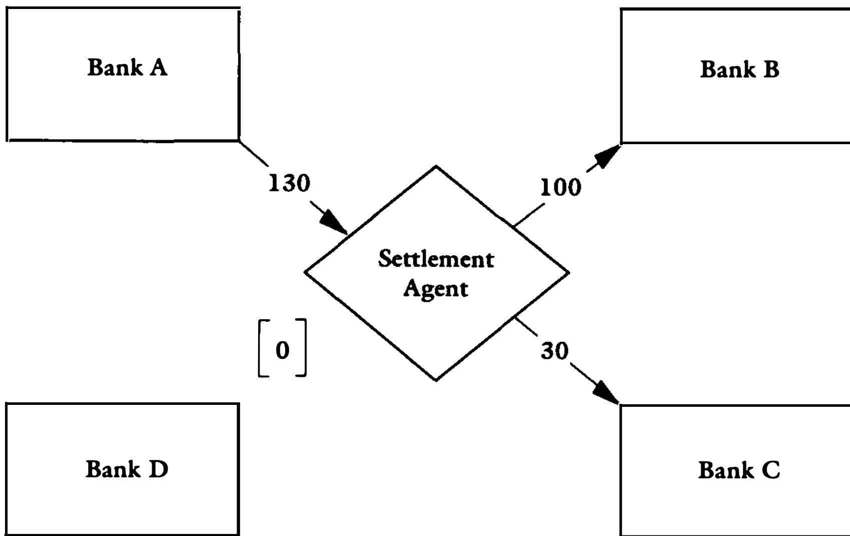


Figure 5. Multilateral Netting: Settlement Phase



Note: Number of payments = 3; total volume of payments = 130.

situations involving netting should be carefully distinguished, in particular, the netting of contractual commitments as opposed to the netting of payments, and bilateral, as opposed to multilateral, netting arrangements.

Netting of contractual commitments is carried out in respect of a variety of contracts, such as foreign exchange contracts, repurchase agreements, securities trades, and derivatives (swaps, options, and forward transactions). Such netting of obligations is always bilateral in essence.[37] Indeed, the so-called multilateral netting of contractual commitments is a shorthand expression for multiple bilateral netting. In these systems (practiced by a number of clearinghouses), a central counterparty is always involved as principal,[38] and, therefore, every contractual relationship (and, consequently, netting) is strictly bilateral between each individual participant and the central counterparty. However, loss-sharing formulas in favor of the central counterparty in the event of the default of a participant are typically established on a multilateral basis.

Netting of contractual commitments reflects the complexity of the underlying (bilateral) contractual relationship. This netting is normally based on master agreements[39] providing for a combination of various legal mechanisms, such as setoff, acceleration, novation, and close-out provisions, the purpose of which is to ensure that in the event of a default

by one party the various bilateral transactions between that party and the same counterparty are liquidated in one net close-out amount. One of the main difficulties to be overcome in this regard is the so-called cherry-picking provision contained in certain statutes. This provision permits the receiver of an insolvent bank to select from among the various pending bilateral transactions those that are to the advantage of the insolvent bank and to require the counterparty to carry them out, while leaving the counterparty as an unsecured creditor for any profits accrued on other transactions with the insolvent bank. Additional problems arise in connection with multiproduct and multibranch netting, especially when conflict of laws issues are involved.

Ultimately, the determining criterion is whether such netting arrangements are enforceable in the event of insolvency of the counterparty. This is also the criterion establishing whether net exposure (rather than the much higher gross exposure) may be taken as a basis for calculating capital requirements. On the basis of this criterion, the Basle Committee on Banking Supervision recognized certain forms of bilateral netting arrangements for capital adequacy purposes, thus allowing banks to calculate the capital required with respect to swap and similar contracts on the basis of the net exposure rather than on the total gross claims with the same counterparty.[40]

Netting of Payments

Netting of payments is overall somewhat simpler, as it relates to liquidated amounts[41] and can be either bilateral (see Figure 3, bottom panel) or multilateral (Figures 4 and 5).[42] The mechanism used in bilateral net payment systems is similar to the current (or running) account technique and is essentially based on setoff or novation, or both. Legal problems may, however, arise with some statutes, in particular those requiring connexity between the claims concerned as a precondition for the enforceability of setoff in insolvency procedures and those applying the so-called zero-hour rule, which provides for a retroactive effect of the initiation of bankruptcy proceedings.[43]

There is some difficulty in satisfactorily explaining the underlying legal mechanism[44] of multilateral net payment systems, and many of the various attempts made in this regard are not very convincing. Explanations based on assumed assignments or transfers of claims with a view to ensuring bilateral setoff in a multilateral payment system are doomed to fail because the participants in a multilateral payment system usually have no intention of assigning claims (indeed, the formal requirements for valid assignments are often not fulfilled), and because the reduction of multilateral netting to successive pairs of bilateral claims is both impractical and

totally artificial. Furthermore, the idea of a multilateral setoff of nonmutual claims is difficult to reconcile with the classical idea of setoff, which is based on reciprocal claims. A more convincing analysis is based on the concept that there is a multilateral, conditional debt remission among participants, which becomes effective only upon settlement of all net balances; however, such an analysis is arguably not very different from the idea of a sort of "multilateral setoff," which has been rejected by legal purists. In any event, the recognition and enforceability of the result (that is, the net position) in case of bankruptcy or similar collective procedures are more important thatn the precise analysis on the basis of legal theory.

Risks and Risk Reduction

Risks Involved in Payment Systems

The extraordinary growth in volume of international payments over the past few decades has prompted a number of studies on the risks involved in payment systems. These studies have significantly increased awareness of the various risks involved in these systems and have led to risk-reduction programs, domestic legislative measures in several countries, and international initiatives aimed at improving the reliability and safety of payment systems.

Besides possible concerns about the technical reliability of payment systems, potential risks are also linked to the lack of transparency resulting from the implicit credit built into many multilateral payment systems, which could induce participants to become overexposed. Furthermore, a concentration and/or shifting of risks (either among participants or even to the central bank concerned) might have a detrimental effect. Finally, the most important issues relate to the consequences for other participants of any failure to settle by a participating bank (liquidity risk and credit risk) and even for the whole system (systemic risk).

Cross-border payment schemes involve additional problems arising from the continuing fragmentation among national legal systems (and their potential disharmonies), as well as among currencies and supervisory authorities. This fragmentation contrasts with the clear trend toward globalizing financial activities. In the case of foreign exchange or securities transactions, the lack of simultaneity in the performance of bilateral obligations (either "payment versus payment" or "delivery versus payment" (DVP)) gives rise to currency settlement risk (Herstatt risk) and to the comparable risk attending the delivery of securities in advance of payment (or, in the reverse case, payment in advance of delivery).

There are six main categories of risk involved in payment and settlement systems:

- *Liquidity risk* is the risk arising from a participant's failure to settle a net debit position when due because the participant does not have enough liquid assets.
- *Credit risk (exposure)* is the risk arising from a participant's failure to settle an obligation for full value, either when due or later (for example, as a result of insolvency).
- *Systemic risk* is the risk that the failure of one participant to settle will cause other participants (or financial firms) to be unable to meet their obligations when due, giving rise to a chain reaction.
- *Gridlock risk* is the risk in a gross settlement or payment system that one or more participants defer the performance of their settlements until they have received sufficient credits from other participants, thereby preventing the system from starting to work because "the pump is not primed."
- *Herstatt risk* (cross-currency settlement risk) is the risk relating to the settlement of foreign exchange contracts that arises when one of the parties to a contract pays out one currency prior to receiving payment from the counterparty. (In other words, there is a cross-currency settlement risk arising from a lack of simultaneity in performing bilateral contracts.)
- *Securities settlement risk* is the risk relating to the settlement of securities transactions that arises when a party either delivers securities prior to receiving payment or effects payment before taking delivery of the securities, resulting in a lack of simultaneity in performing a bilateral contract. The DVP mechanism aims to eliminate this risk.

Risk Reduction in Net Payment Systems

The best illustration of various measures that can and should be taken to reduce the risks inherent in payment systems is the risk-reduction program applied by the Clearing House Interbank Payments System (CHIPS), which is a multilateral net payment system:[45]

- In 1981, same-day settlement replaced next-day settlement.
- In 1984, bilateral caps on net debit positions were introduced.
- In 1986, multilateral caps were implemented.
- In 1990, settlement finality was introduced through loss-sharing.

Other possible measures that could be implemented to reduce risk include setting appropriate membership criteria (for example, limiting membership to credit institutions and imposing capital and technical requirements), monitoring net balances on a real-time basis, and establishing emergency credit facilities (in general, against preposted collateral provided by each participant).

In net payment systems, the most problematic feature is the lapse of time between the opening of the system, when payment messages begin to be exchanged (and, more noticeably, after the determination of the net balances), and the finality of payments within the system, which occurs only upon settlement of all net positions at the end of the day. Any failure of a participant during this time lapse could create liquidity problems for other participants, in particular those who, relying on announced payments and on net positions that are not certain to be settled, may have passed on amounts to their customers as beneficiaries of the anticipated payments. These circumstances may even give rise to a credit risk and, if they trigger a chain reaction, could disrupt the whole system. For that reason, central banks and supervisory authorities are urging the introduction of various schemes to ensure the completion of the daily settlement process, even if the participant with the largest net debit position is unable to settle. Such schemes are based on a "defaulter pays" formula (with each participant preposting collateral), or on a "survivors pay" loss-sharing formula, or on a combination of these two formulas.

There are five main categories of risk-reduction measures relevant to net payment systems:

- ***Admission criteria***, which include restricting membership to credit (or financial) institutions and setting minimum capital requirements and organizational and technological requirements;
- ***Monitoring of positions***, for example, by implementing individual and multilateral debit and/or credit caps and by introducing or using real-time monitoring;
- ***Exposure reduction***, by instituting same-day settlement (thus reducing the duration of any implicit credit), pricing daylight overdraft facilities, holding more than one netting session per day, and proceeding to bilateral setoff prior to netting;
- ***Protecting or ensuring liquidity***, including, for example, by establishing mutual credit facilities and a central bank credit facility; and
- ***"Guaranteeing" of settlement***, for example, by implementing "defaulter pays" schemes (using preposted collateral) and "survivors pay" schemes (using loss-sharing arrangements).

Risk Reduction in Gross Payment Systems

While gross payment systems ensure the immediate finality of each individual payment within the system, they do not save routine liquidity and may, in certain situations, run the risk of gridlock.[46] The modern technology of RTGS systems may reduce the impact of that risk by making settlement almost immediate. Furthermore, the provision of adequate intraday liquidity through overdraft facilities (against collateral) or repurchase agreements would to a large extent enable payment queues and gridlock situations to be avoided. Finally, some elements of netting are introduced in "optimized" gross settlement systems, which try to effect, at predetermined times of the day, certain groups of payments that can thus be "prenetted."[47] In fact, such systems are hybrid systems, with elements of both net and gross settlement systems. In a number of countries, net and gross settlement systems coexist and supplement each other in a very useful way: it appears that net settlement systems are particularly appropriate for channeling large numbers of small payments (which are thus rationalized), while RTGS systems minimize risks for large-value interbank payments.

Three main categories of risk-reduction measures are relevant to RTGS systems:

- *Admission criteria*, which restrict admission to credit (or financial) institutions, or set minimum capital requirements or organizational and technological requirements;
- *Time of settlement*, including real-time settlements, queuing arrangements, or the pricing of late settlements; and
- *Liquidity protection* measures, such as retrieving chains of payments, prenetting groups of payments at specific times, or establishing liquidity facilities (granting explicit credit).

Domestic Legislative Developments and International Initiatives

Legislative Developments in Various Countries

In various countries, legislation—often inspired by the central bank or regulatory agencies—has been or is being introduced to establish full enforceability of netting arrangements in insolvency proceedings. Depending on the legislation, these provisions apply to bilateral netting, multilateral netting, netting of payments, and/or netting of contractual commitments.

In this connection, for example the *United States* has implemented provisions related to netting in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989; the Bankruptcy: Swap Agreements and Forward Contracts Act of 1990; and the Federal Deposit Insurance Corporation Improvement Act of 1991.[48] Moreover, amendments were made to the New York State Banking Law in 1993.[49] In the *United Kingdom*, the Companies Act, 1989, Chapter 40, §§ 159, 170, and Schedule 21 (Parts II and III), refer to netting. *Belgium* enacted Loi du 22 mars 1993, Art. 157. *France* passed Loi no. 93–1444 du 31 décembre 1993, Art. 4 (Art. 93–1, Loi no. 84–46 du 24 janvier 1984 relative à l'activité et au contrôle des établissements de crédit), and Art. 8 (Art. 2, Loi du 28 mars 1885 sur les marchés à terme). *Germany* enacted Insolvenzordnung vom 5. Oktober 1994, § 104, Bundesgesetzblatt I S. 2866. *Sweden* passed Law 1995: 318 amending Law 1991: 980 on Trade with Financial Instruments, which entered into force on April 1, 1995. *Switzerland* enacted Bundesgesetz über Schuldbetreibung und Konkurs, Art. 211bis. It should be emphasized that some of these texts are of general application, while others only apply in the financial sector or to specific types of transactions.[50]

International Initiatives Under the Auspices of the Group of Ten Central Banks and the Basle Committee on Banking Supervision

Some of the domestic legislative measures were encouraged, if not provoked, by a number of international studies on payment and settlement systems and netting. These studies, which have themselves benefited from the experience acquired in various countries, were essentially prepared by committees meeting at the Bank for International Settlements in Basle under the auspices of the central banks of the Group of Ten countries, including the Committee on Payment and Settlement Systems and the Basle Committee on Banking Supervision, as well as by working parties set up by the central banks of the member states of the European Community (EC), which is now the European Union (EU).[51]

Group of Ten Studies

The *Report on Netting Schemes* (the Angell Report), published in 1989, was the first of the Group of Ten studies devoted to these topics. It examined the efficiency of netting systems and the risks involved and raised the question of whether netting arrangements were in all cases legally binding and enforceable.

The *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* (the Lamfalussy Report),

published in November 1990, concluded that effective reductions in exposures depended upon the ability of netting arrangements to produce legally binding net exposures that could withstand challenge. A set of six ***minimum standards*** was set out in this report for the design and operation of cross-border and multicurrency netting schemes as a first step toward ensuring adequate risk-management practices:

- well-founded legal basis;
- clear understanding by participants of impact of the scheme on financial risks;
- clearly defined procedures for the management of credit and liquidity risks in multilateral netting systems;
- ensuring the timely completion of daily settlement in the event of inability to settle by the participant with the largest net debit position;
- suitable criteria for admission; and
- operational reliability of technical systems and backup facilities.

A further important report published in September 1992 under the title *Delivery versus Payment in Securities Settlement Systems* is essentially concerned with risks involved in securities clearance and settlement between direct participants in a single settlement system. This report was supplemented in March 1995 by a detailed study entitled *Cross-Border Securities Settlements.* The latter settlements often involve additional intermediaries, such as local or international central securities depositories (for example, Euroclear and Cedel).

A report published in September 1993 under the title *Central Bank Payment and Settlement Services with Respect to Cross-border and Multicurrency Transactions* (the Noël Report) examined a range of options that central banks might consider in an effort to reduce risk and increase efficiency in the settlement of cross-border and multicurrency interbank transactions. The options considered include modifying or making available certain home-currency payment and settlement services; extending the operating hours of home-currency large-value funds transfer systems; establishing cross-border operational links between these payment systems; and developing multicurrency payment and settlement services.

Basle Committee Studies

The Basle Committee on Banking Supervision (which comprises representatives of the central banks and supervisory authorities of the Group

of Ten countries and Luxembourg) has considered on various occasions recognizing netting arrangements in the calculation of capital requirements with regard to forward transactions, swaps, options, and similar derivatives contracts. To the extent that certain forms of bilateral netting of contractual commitments are recognized, the capital required in this regard can be calculated on the basis of the net exposure, rather than on the much larger total amount of the gross claims against the same counterparty.

The initial version of the Basle Capital Accord, published in July 1988, restricted the recognition of netting arrangements to "netting by novation."[52] This form of netting is defined for the purposes of the accord as a bilateral contract under which any obligation between a bank and its counterparty "to deliver a given currency on a given [value] date is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single net amount for the previous gross obligations."[53]

In April 1993, the Basle Committee published the consultative proposal, *The Supervisory Recognition of Netting for Capital Adequacy Purposes.* Following positive reactions to this proposal, the Basle Committee issued in July 1994 and April 1995 an amendment to the Basle Capital Accord of 1988 extending the recognition of bilateral netting of (forward) contractual commitments for capital adequacy purposes.[54] As a result, besides netting by novation, other legally valid forms of bilateral netting are now recognized, provided that the bank has either a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of individual transactions if a counterparty fails to perform because of default, bankruptcy, liquidation, or similar circumstances. This amendment excludes all netting arrangements allowing any possibility of cherry-picking, as well as those containing a "walkaway clause" (that is, a provision that permits a non-defaulting counterparty to make only limited payments, or no payment at all, to the estate of the defaulter, even if the defaulter is a net creditor). All banking supervisory authorities concerned must be satisfied (after receiving appropriate legal opinions) that the netting arrangement is enforceable under the laws of each of the relevant jurisdictions. It should be noted that these provisions apply only to netting of (forward) contractual commitments and not to the netting of payments, which is not "recognized in the capital framework since the counterparty's gross obligations are not in any way affected."[55]

International Initiatives Under the Auspices of the EU Central Banks

In the field of payment systems, the central banks of the EU have concentrated specifically on systemic issues, in particular in connection with the implementation of the European Monetary Union (EMU). A number of reports were published by the Working Group on EU Payment Systems, established by the EU central banks. This group, now known as the Working Group on EU Payment Systems, continued its studies from the beginning of 1994 under the auspices of the European Monetary Institute (EMI).

A seminal report was published by the Working Group in September 1992 under the title *Issues of Common Concern to EU Central Banks in the Field of Payment Systems* (the Padoa-Schioppa Report). This report analyzes the main features of payment systems in the EU countries, the impact of the single market on EU payment systems, and the possible consequences of EMU for payment systems. On this basis, four lines of action were suggested, namely, (i) the definition of principles for the cooperative oversight of payment systems in EU countries; (ii) the establishment and implementation of minimum common features for domestic systems; (iii) preparatory work in the area of large-value cross-border payments in anticipation of EMU; and (iv) continuation of oversight of the ECU Clearing and Settlement System.

As a follow-up to the second line of action, a further report was published by the Working Group in November 1993 under the title *Minimum Common Features for Domestic Payment Systems.* This document concludes with ten principles that should serve as guidelines to establish minimum common features of payment systems within the EU:

- limitation of access to interbank funds transfer systems to credit institutions and other properly supervised bodies;
- no discrimination in access;
- transparency of access criteria;
- introduction of RTGS systems;
- enhancement of large-value net settlement systems;
- flexible approach with regard to other interbank funds transfer systems;
- sound and enforceable legal basis;
- technical compatibility and efficiency;

- new, consistent pricing policies of EU central banks; and
- overlap between operating hours.[56]

It was agreed that progress made in implementing these principles should be evaluated once a year by EU central banks. The first annual report in this respect was addressed to the EMI Council in February 1995 under the title *Developments in EU Payment Systems in 1994.*

On November 15, 1994, the EMI released a note on *The EMI's Intentions with Regard to Cross-Border Payments in Stage III,* which describes why EU central banks intend to link the RTGS systems that operate in their respective countries. In May 1995, the Working Group on EU Payment Systems published a *Report to the Council of the EMI on the TARGET System,* which had been adopted by the EMI Council in March 1995. The TARGET system (an acronym for **T**rans-European **A**utomated **R**eal-Time **G**ross Settlement **E**xpress **T**ransfer system) is a payment system that will link the national RTGS systems. Within TARGET, the infrastructure and procedures used to process cross-border payments will be called the Interlinking system. The two objectives of the TARGET system will be to serve the needs of the single monetary policy in the third stage of EMU and to improve the soundness of EU payment systems through "a wider use of RTGS procedures which are the safest payment mechanism to process large-value payments."[57] Only payments related to the implementation of the single monetary policy in the third stage must be processed through TARGET, while alternative routes, such as correspondent banking and netting systems, will continue to be available for other payments.

Other EU Initiatives

Although the European Commission is particularly concerned with consumer protection in the field of international (and intra-European) payments,[58] it has also caused several draft directives to be prepared that are related to, or have some bearing on, risk reduction in payment systems or netting arrangements.

Mention should first be made in this connection of the Draft Articles on Settlement Finality in EU Payment Systems,[59] which are intended to be proposed as a directive in the future. The draft articles contain a provision giving binding effect to bilateral and multilateral netting in payment systems, provided that payment orders included in the netting are transmitted to the system before opening any insolvency procedure. Another provision ensures that, with respect to conflict of laws issues in the case of a participant's insolvency, the law of the member state where the payment system is located would govern the effects of insolvency

upon the rights and duties relating to the payments included in a gross or net payment system. A further provision would abolish the zero-hour rule, which gives retroactive effect to insolvency procedures.

The amended proposal for a Council directive concerning the reorganization and winding-up of credit institutions[60] is also relevant in this connection. While it envisages that the winding-up of an EU credit institution would normally be entirely governed by the law of its home country, the proposal provides for a number of exceptions in favor of the law chosen by the parties (for example, in netting agreements) or of the local law (for example, for payment systems and regulated markets). It would be desirable for the final text also to provide expressly for the enforceability of bilateral and multilateral netting in the winding-up of credit institutions.

As regards the netting of contractual commitments, a specific Council directive is being prepared amending an earlier directive with respect to the supervisory recognition of "contractual netting" by the competent authorities.[61] The proposal would make member states in which the validity of contractual netting is not yet legally recognized introduce the appropriate legislation to this effect; this would be achieved through Annex II to Directive 89/647/EEC (on a solvency ratio for credit institutions), which provides for the recognition of contracts for novation and other netting agreements under conditions similar to those contained in the amended Basle Capital Accord. Finally, it should be noted that the EU Draft Bankruptcy Convention of 1982, as revised in 1994, also has implications for the validity of netting arrangements.[62]

International Harmonization of Legislation on Netting and Payment Systems

The various international initiatives undertaken so far with regard to netting arrangements and payment systems, in particular under the auspices of the Group of Ten central banks, the EU central banks, and the Basle Committee on Banking Supervision, have already made a very valuable contribution toward international financial stability. In particular, significant progress has been made in identifying risks, with a view to enhancing the efficiency and security of payment systems and netting arrangements.

Following on these initiatives, many countries in which important financial centers are located have enacted either specific or general legislation improving the legal enforceability of netting arrangements in general and bankruptcy or similar proceedings in particular. From a formal point of view, the legislative approaches followed in various countries dif-

fer somewhat: some countries amended general legislation, while others amended or supplemented bankruptcy laws, regulations relating to banking and banking supervision, or legal rules relating to specific banking or market transactions. Furthermore, there are some substantive differences among countries as to the scope of application and the prerequisites for the enforceability of netting arrangements. Nevertheless, despite this lack of harmonization in the specific rules, the domestic legislative developments to date show a remarkable trend of convergence toward their overall objective.

Notwithstanding these significant achievements, there are still a number of outstanding issues (in particular relating to cross-border and multicurrency payment systems and netting arrangements), that result from the existing fragmentation and disharmony among national legal systems and on which there is still room for progress to be made. Indeed, to assess the legal validity of cross-border netting arrangements, it is necessary to examine the precise scope and contents not only of the laws governing the netting system or arrangements in question, but also of the laws applicable to the insolvency of any participant in the system.[63] For these reasons, it would be in the interests of international financial stability if the rules establishing the enforceability of netting were to be adopted generally and the various domestic laws harmonized, at least in certain essential aspects. Such harmonized provisions should cover all financial transactions, including multibranch and multicurrency netting, as well as cross-border payment and settlement systems, and they should apply to all participants in such transactions or systems.

The international cooperation resulting from these initiatives must, therefore, continue and should be intensified. International harmonization of the law of payments could be pursued, perhaps by taking account of the model law of the United Nations Commission on International Trade Law and the International Law Association model rules on the time of payment of monetary obligations, or through other initiatives focusing on specific issues, including finality of payment.[64] In order to overcome the remaining uncertainties and disparities among various domestic law rules applicable to netting and payment systems, an international consensus—if not a fully fledged international convention—should be reached, setting out minimum standards for rules of law ensuring full enforceability of net positions under insolvency law, as well as mutual recognition of the effectiveness of payment systems, in particular arrangements for the multilateral netting of payments.[65] The draft EU directive regarding recognition of contractual netting[66] paves the way in this direction. In any event, pending broad-based international harmonization of domestic law rules in this field, it is clearly desirable to encourage full use of private contract law mechanisms that could ensure

enforceability of netting arrangements and protect against liquidity and credit risks for payment systems resulting from any failure by a member to settle its obligations. However, this approach cannot substitute in all respects for international harmonization of applicable domestic law rules, because mandatory provisions of insolvency law might impair the effectiveness of such mechanisms.

25B. Risks in the Large-Value Payment System and the Role of Netting

H. RODGIN COHEN

Real-Time Gross Settlement

The principal systemic risk that preoccupies central banks today is settlement risk in respect of large-value payments. The collapse of a major bank that is active in large-value payments could cause a chain reaction among other major banks, particularly if nations adopt local depositor preference or similar rules.[1] A possibly even greater concern is that such a collapse could slow and ultimately freeze large-value payments, which would have reverberations throughout the entire international economy.

At its heart, settlement risk is a form of credit risk. A loss will occur only if the credit of a bank deteriorates to the point where it is no longer able to make the payments that it is obligated or instructed to make. However, settlement risk is a unique type of credit risk. It is limited in duration but constantly repetitive. Moreover, depending upon the relevant legal regime, the liabilities in respect of failed settlement may far exceed the bank's net worth.

A number of central bankers and others have proposed an answer to the settlement risk problem: all large-value payments should be made on a real-time gross settlement basis. However, a real-time gross settlement solution can be implemented only at a substantial cost to the private banking system. Such a settlement requires the intermediation of a central bank, which alone can provide certainty of payment. In addition, central banks tend to be notoriously, albeit quite properly, conservative in their lending standards. As a general matter, they may not be prepared to make large payments on behalf of a bank unless those payments are substantially, if not totally, secured. The collateral required to cover a major bank's large-value payments on a gross basis could amount to billions of dollars. Moreover, because the amount of payments on a given day and at a given time is largely beyond the control of a bank, significant overcollateralization may well be necessary.

The billions of dollars of collateral represent millions of dollars of forgone earnings that would otherwise accrue to the banks if the collateral were not immobilized with the central bank. In part, this loss will occur because a central bank is likely to limit acceptable collateral to low-risk assets that will produce yields below what a bank could attain if it were investing without constraint. Moreover, this collateral could otherwise be

used in a variety of ways to enhance income, such as in the form of repurchase agreements or securities loans, or to reduce borrowing costs. Moreover, the central banks will almost certainly charge for daylight overdrafts, and these charges are unlikely to be subsidized. The potential for daylight overdrafts will inevitably increase for banks active in large-value payments.

There is a less tangible but potentially even greater loss for the private banking system if large-value payments become the province of the central banks. At some point in time—and, in the United States, it may come sooner rather than later—the question will be raised why the central bank's large-value payment services should be limited to banks. Why should not major securities and insurance firms and other makers of large payments have direct access to those accounts? Why should they not enjoy the same privilege as banks of opening accounts with the central bank and routing large-value payments through them? Even if the central bank itself desires to restrict its payment services to banks, legislative forces, prompted by nonbank financial service companies, may compel a different outcome.

Such a result, in which nonbanks could receive access to a central bank's large-value payment services, would contribute to the continuing deterioration of the banking franchise. Whatever one concludes about the health or the market share of the banking system, it cannot be gainsaid that the special franchise long enjoyed by banks for banking services has been deeply eroded by economic, legislative, and regulatory developments. Indeed, the one area in which banks have been able to enjoy a continued special position, relatively free from nonbank competitors, is the payment system. The loss of this position would not only reduce the income earned from payment services but also undermine entire banking relationships that are built around those services. Moreover, the addition of scores of participants into the large-value payments process is not effective risk reduction.

Another concern with respect to the impact of central bank real-time gross settlement on private banks is apparently so sensitive that it is rarely discussed. Arguably, regulation works best when there is a balance of power between the regulator and the regulated, that is, when the regulator has power over but cannot totally dominate the regulated. That balance of power can become destabilized if the regulator has not only regulatory authority but also commercial control. The regulator can then enforce its authority not only through the normal regulatory process but also through its total control of access to the large-value payment system.

There is a another potential defect of real-time gross settlement that rarely seems to be mentioned. Real-time settlement may be real within a

single country, but it is not necessarily real on a multinational basis. Assume, for example, that the First National Bank of Fredonia has made a $500 million payment to Morgan Guaranty Trust through the Central Bank of Fredonia. If, before the end of the day, Fredonia's Government is overthrown by a coup and all payments by the Central Bank are disavowed by the new Government, has Morgan Guaranty Trust received payment? Perhaps Morgan will get paid if the Central Bank of Fredonia has sufficient collateral with the Federal Reserve Bank of New York, and if the Federal Reserve Bank has no claims against the Central Bank. Otherwise, Morgan Guaranty Trust has only a claim and not a payment. In addition, disavowal may occur as a result of something less radical than revolution, war, or natural catastrophe. Disavowal may be occasioned by a commercial judgment, although that is unlikely to be exercised except in extreme circumstances.

At this point, one could ask whether central banks should be deterred from engaging in real-time gross settlement by its possible negative impact on the private banking sector. Central banks should at least take this possibility into consideration. Given the symbiotic relationship between central banks and private sector banks, diminishing the importance of the private banking sector could likewise diminish the influence of central banks and their ability to function.

More generally, if one truly believes in a private sector economy, one should conclude that a governmental agency should regulate risk rather than absorb it. This principle is particularly relevant in this situation, in which the discipline of large-value payment systems both discourages excessive risk and serves as a valuable early-warning system if serious problems emerge.

Notwithstanding the flaws of real-time gross settlement, the systemic concerns over settlement risk are so great that they are likely to prompt comprehensive real-time gross settlement unless that risk can otherwise be reduced to an acceptable level. The principal means to reduce settlement risk is legally binding netting on an international basis, and the remainder of the chapter focuses on netting.

Netting

Central banks' concerns about settlement risk are not misplaced. During the past few years, the financial services industry generally—and the banking industry specifically—has experienced severe problems, including failures and near failures of significant institutions. Although no major systemic problems have resulted, there is no guarantee that this record can be continued. To a large extent, the absence of a "falling

domino" failure in recent years can be attributed to prompt and effective central bank action and sound private sector practices. However, to some extent, this situation reflects an element of luck. In the event of a future liquidity or solvency crisis at a large financial institution, the luck may not hold. In the United States, the congressional override of the "too-big-to-fail" doctrine could compromise the ability and flexibility of regulators to deal with a crisis at a large U.S. bank. In another country, the government in power may not have the will or the ability to save a seriously troubled bank. Another concern is that the crisis could occur at a financial institution that is largely outside the regulatory scheme.

If a large financial institution suddenly collapses, the absence of legally binding netting arrangements could send shock waves throughout the financial world. Other financial institutions are likely to hold billions of dollars of gross claims against the failed institution. If these claims are not netted down to a small fraction of the gross amount, the other financial institutions will face major claims against them, with uncertain prospects for their recovery of offsetting amounts. Depositor preference and similar priority statutes seriously compound the potential loss.

A 1990 Bank for International Settlements report concluded that netting reduced systemic risk, provided that the netting scheme was legally binding in all relevant jurisdictions.[2] This conclusion is the inescapable function of the high volume and velocity of financial transactions, which mandate large gross exposures. Even if it can be assumed that these exposures would not be as large if netting were unavailable, the remaining exposures would still be so high that the sudden collapse of a large financial institution not supported by its government would likely create significant systemic problems.

Accordingly, the key question is whether it is possible to construct a legally binding netting scheme. A "perhaps" or even a "probably" is not a satisfactory answer. A netting scheme that has any meaningful element of legal uncertainty may well be worse than no netting scheme.

The only way to achieve the necessary level of certainty is a legislative solution. That legislative solution might be taken on an international level, whether under the auspices of the Bank for International Settlements or the United Nations, or through multiple bilateral efforts. The legislation could take the form of either a model code enacted in each country or a treaty. Absent specific legislation in the relevant countries, there can be no certainty that netting will be legally cognizable. This uncertainty increases if the focus is multilateral netting, which, unlike bilateral netting, lacks common or civil law underpinnings.

The U.S. experience illustrates the need for multijurisdictional and uniform legislation that is carefully crafted to meet the demands of the modern financial system. Even with a common approach to legal issues that is facilitated by a common law heritage, pre-emptive federal legislation was necessary to ensure a high degree of certainty as to the legal validity of netting in the United States.

Two significant U.S. legislative steps toward creating legal certainty with respect to netting were the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)[3] and the enactment of amendments to the U.S. Bankruptcy Code in 1990.[4] Both provided greater certainty as to the enforceability of netting arrangements in the insolvency of entities covered by their provisions—banks in the case of FIRREA, and general corporations in the case of the Bankruptcy Code amendments.

These legislative initiatives were limited, however, in a number of important respects. Accordingly, Congress adopted broad federal netting legislation in Subtitle A of Title IV of the Federal Deposit Insurance Corporation Improvement Act of 1991 (hereinafter Title IV of FDICIA).[5] The genesis of this legislation was the New York Clearing House Interbank Payments System (CHIPS). From its inception in the early 1970s, the rules of CHIPS provided that the system would be settled on a multilateral netting basis. Following the collapse of the Herstatt Bank,[6] which almost paralyzed CHIPS although Herstatt was not a CHIPS participant, concern was increasingly expressed that the CHIPS netting provisions might not work if challenged in a court of law. This concern was heightened by the exponential growth in the volume of payments over CHIPS. Consequently, counsel to CHIPS was asked to issue an opinion on the validity of its multilateral netting rules. The resulting opinion strongly suggested that there was a significant element of uncertainty that could be resolved only by federal legislation. In very large part due to the Federal Reserve's skillful advocacy, Congress then enacted legislation to validate large-value payment netting. The Federal Reserve also deserves credit for substantially expanding the original legislative proposal to cover a wide range of netting arrangements.

Counsel to CHIPS thought that only federal law could provide the necessary certainty because, in the United States, different insolvency laws are applicable to banks, insurance companies, broker-dealers, and other business corporations. Indeed, owing to differences in state law, there is not even complete uniformity in the insolvency laws applicable to banks or insurance companies.

The analogy to cross-border insolvency and netting issues is appropriate. Participants in CHIPS are based in a variety of states and countries

and are bound by a number of legal schemes. In some cases (such as a branch of a bank operating outside the bank's home jurisdiction), more than one set of insolvency laws may arguably be applicable. Uniformity across states can be achieved by national legislation. Likewise, in the modern financial markets, transactions frequently involve participants from more than one nation, and uniformity can best be achieved by international legislation.

Even with all the effort that went into its preparation and adoption, Title IV of FDICIA[7] did not achieve total legal certainty for netting. The pre-emption of any contrary federal or state law in the United States seems clear. Title IV provides that, "notwithstanding any other provision of law," netting arrangements made with respect to rights and obligations among financial institutions in the United States will be respected.[8]

However, if a foreign bank fails, will a receiver in that foreign nation honor the CHIPS contractual arrangements and the choice of U.S. law? Or will that receiver say that the netting so clearly violates the foreign nation's public policy that it must be disallowed? This is not merely a theoretical concern. If netting can be upset, local depositors will gain at the expense of foreign banks.

From the perspective of a central bank, a slight increase in depositor payout is not worth the risk of serious disruption of the international financial system. Central bankers, however, will not necessarily make that decision; it may well be made by a judicial or political authority in the country of the failed bank that is more responsive to the claims of local depositors than to the needs of the international financial system. Accordingly, true legal certainty can be attained only if each relevant country enacts legislation or assumes a treaty obligation that recognizes the legal effectiveness of netting.

Admittedly, a risk remains that a country will choose to ignore or repudiate its own laws. However, the effectiveness of repudiation may be limited as a practical matter because of the threat of retaliatory repudiation, given that most major financial institutions have assets located in various jurisdictions. Moreover, the realistic objective of legally binding netting is not the elimination of risk, any more than it is the objective of real-time gross settlement; rather, it is the minimization of risk.

Legal Issues Arising from Netting Arrangements

Several legal issues arise in the context of the legislated validation of netting arrangements. The first legal issue is the scope of netting legislation in terms of the institutions covered. The legal validation of netting

in Title IV of FDICIA is limited to netting arrangements among financial institutions. The statute does not deal with netting arrangements involving nonfinancial institutions, apparently on the theory that they do not create a significant systemic risk. This approach reflected a political compromise. Congress did not wish to engage in a broad rewriting of the U.S. bankruptcy laws. Thus, it adopted a more narrow focus, addressing only obligations among market professionals. However, a number of nonfinancial end users of financial products have large payment and other exposures, and the failure of one of these end users could create systemic problems.

That approach of limiting netting to market professionals is likely to improve prospects for legislative action in other countries because it will infringe to a lesser extent on general insolvency schemes. However, given the magnitude of the positions that are maintained by some nonfinancial end users, an international solution should, if politically feasible, encompass them.

A second and related legal issue is the degree of flexibility accorded to the central bank in administering netting legislation. A critical feature of Title IV of FDICIA is the flexibility that it affords the Federal Reserve Board to extend FDICIA coverage to address the evolving needs of the marketplace. In the statute itself, Congress defined "financial institution" as "a broker or dealer, a depository institution, a futures commission merchant. . . ."[9] However, it also gave the Federal Reserve Board the authority to expand the coverage of the FDICIA by expanding the definition of "financial institution."[10] The wisdom of this delegation of authority was immediately proven in the application of the FDICIA to CHIPS.

As mentioned, the FDICIA had originally been intended in large part to address the need for certainty in the CHIPS net settlement procedures. After the legislation was passed, however, a question arose whether three institutions that were CHIPS participants fell within the definition of financial institution in Title IV of FDICIA. The Federal Reserve's first use of the authority delegated to it under the FDICIA was to define in a private letter ruling those CHIPS participants as financial institutions for purposes of their participation in CHIPS. In February 1994, the Federal Reserve took a more generalized approach by adopting a regulation expanding the definition of financial institution to include all market participants, irrespective of the nature of their charter or their place of organization.[11] These institutions must meet certain quantitative thresholds and hold themselves out as making a two-way market in some financial contract.

A third legal issue is the scope of netting legislation in terms of both bilateral and multilateral situations. Title IV of FDICIA recognizes the validity of multilateral, as well as bilateral, netting, provided that all the participants in the multilateral agreement are financial institutions. In view of the increasing complexity and velocity of international payments and other financial transactions, the validation of multilateral netting is essential to reduce systemic risk.

A fourth legal issue is the degree of specificity of the structural requirements for valid netting. Title IV of FDICIA does not attempt to prescribe rules for multilateral netting, such as a central counterparty or specific collateral. This decision seems right because the flexibility necessary to deal with a variety of extensive and intricate problems and situations should not be circumscribed in advance. Nonetheless, collateral requirements will be necessary in any large payment system to deal with liquidity and credit risk.

A fifth legal issue relates to the scope of netting legislation in terms of obligations covered. This issue is not directly relevant to payment systems, but it indirectly relates to the level of shock that a payment system may be forced to withstand. Title IV of FDICIA broadly covers all entitlements or obligations of a financial institution to make or receive a payment, including those arising as a result of closeout or liquidation of a counterparty position. This approach seems far superior to any attempt to define with precision the types of obligations covered. Any attempt to provide specific definitions of the obligations covered will likely lead to ambiguities that will limit the utility of netting legislation at the time of a financial crisis.

The sixth legal issue relates to the scope of netting legislation in terms of the same or different currencies. Title IV of FDICIA permits netting of obligations with different currencies. Again, this provision seems correct. A netting scheme that accommodates different currencies maximizes liquidity and minimizes systemic risk. This issue is of particular relevance to the payment systems of the future, which might well evolve into multicurrency systems. Such legislation should preferably not attempt to establish valuation standards but require only that the valuation procedures be established by contract.

A seventh legal issue is the scope of netting legislation in terms of obligations of different maturities. Again, the goals of liquidity and flexibility argue for breadth, and Title IV of FDICIA permits netting of different maturities.

An eighth legal issue is conflict of law. Title IV of FDICIA applies only if U.S. law is chosen. As discussed above, however, there is a risk that,

even if U.S. law is chosen, a court outside the United States might hold that the law of the failed institution's jurisdiction should be applied. In that event, even if both relevant jurisdictions have enacted netting legislation, there may be some differences in the statutes. In addition, in the absence of a legally recognized contractual choice of law, the number of legal theories as to the proper choice of law is a function of the number of possible laws multiplied by the creativity and imagination of the lawyers involved. Accordingly, the netting statutes should recognize a contractual choice of law.

The ninth and last legal issue is whether a netting contract should apply just to the local branch of an international bank operating outside its home country or to the entire bank. Although this issue raises significant supervisory issues, it could be argued that netting contracts should apply to the entire institution, in order to avoid substantial confusion and to make the netting scheme more effective.

Additional Considerations

Two points—one related to netting and one to payment systems generally—are suggested by the foregoing. First, if there is legally binding netting, it should be treated as such for purposes of the Basle capital guidelines.[12] The sole question should be the legal effectiveness of the netting system. If the system is legally effective, the only credit exposure is the net amount, and the type of netting should be irrelevant.

Second, a significant issue for any payment system is legal finality. Can a payment, once released, be retracted or unwound? The focus of this issue appears to be CHIPS Rules 2 and 13(k).[13] These rules become relevant only if the extensive CHIPS measures for dealing with one or more defaulting participants are unable to produce a settlement, which could occur only in the event of multiple large failures. In those circumstances, all payment messages sent during a day can, but not necessarily will be, returned to a storage mode, and any obligation of a sending participant is annulled.

Central bankers are increasingly expressing concern about the absence of finality, presumably for two reasons. First, the absence of finality encourages banks to take excessive risk because of the safety valve of an unwind. Second, an unwind—a failure to settle—would cause chaos in the world's financial markets.

Both of these concerns can easily be addressed. First, it is close to inconceivable that a bank would make payments of billions of dollars over CHIPS on the assumption that it would be bailed out of an unwise pay-

ment by an unwind. The predicate of an unwind would occur only in a catastrophic situation, and there could be no assurance that the response, even then, would be an unwind.

Second, while it is possible that an unwind might contribute to chaos in the financial markets, an existing state of chaos would have led to the unwind. An unwind could not occur unless there had been multiple large bank failures on the same day.

Even if the risks of an unwind mechanism are lower than has been perceived, the question is properly asked whether there are any offsetting benefits. The unwind mechanism was put in place to deal with an event that has never been experienced—an international financial catastrophe involving multiple banks occurring on a single day. It was designed to provide maximum flexibility at a time when flexibility should be at a premium and to avoid rigid rules that could further escalate the crisis. Such a benefit is admittedly intangible, but it could enable the public and private sectors—as it did during the Herstatt collapse—to manage rather than be submerged by a financial crisis.

Conclusion

One prediction that can be made with virtual certainty is that major changes will occur in large-value payment systems. Whatever those changes may be, the development of a legally cognizable netting system on an international basis and at the earliest possible time would promote international financial stability. There are, admittedly, a number of difficult legal issues to be resolved in developing such a system. However, these issues should not discourage a concerted effort from being made; rather, they should demonstrate the pressing need to begin as soon as possible.

COMMENT

ANDREW T. HOOK

Over the past 15–20 years, there has been a significant increase in interest in payment systems and their importance for a country's economy. This comment underlines and develops some points presented in the prior chapters.

Netting Issues

The issue of netting is the focus of much attention in the Group of Ten countries.[1] Debate continues among the central banks and commercial banks on a number of issues. One issue revolves around the advantages and disadvantages of gross or net settlement. To some extent, this issue is one of policy, involving the classic payment system trade-offs among efficiency, safety, and reliability. Another issue is whether the large-value transfer system that is essential to the functioning of market economies should be run and operated by the central bank or by the private sector. When this latter issue is debated in the abstract, it is doubtful that good decisions in practice can be reached. There are simply too many variables and too many unknowns. Progress toward legal certainty in payments must occur in the context of specific systems or arrangements.

Recent legislative and legal developments in the United States in the area of netting[2] illustrate the extent to which change can occur within the context of a specific payment system, the Clearing House for Interbank Payments System (CHIPS). While other institutions outside the membership of CHIPS were involved in different ways, the existence of systemic risk within CHIPS was primarily responsible for driving the process.

Systemic risk poses an acute problem for public policy and the law because time is of the essence in dealing with it. At the time of the risk — for example, when a participant in a net settlement system is unable to cover a large debit—there is typically little time to act. If nothing is done to reduce or eliminate the systemic risk, the damages can be enormous, and they may be permanent. Many different individual interests may be at stake. If there is uncertainty about the outcome, panic reactions may occur. Attempting to balance judiciously and deliberately the public interest, individual interests, and the possible outcomes (which will be very unpredictable) at such a time is not realistic.

The trend in the United States is to treat payments that involve systemic risks as special types of transactions that require a high degree of legal certainty. In a sense, these transactions are protected or insulated from some of the parties that would otherwise directly be involved as claimants. This approach leads to an assured settlement that rules out the risks that would be involved in an unwind. The legal framework is established beforehand, precisely to address systemic risk and to assure a balance of interests if such a risk arises.

Developing a legal framework in a country that supports special treatment for payments involving systemic risks is a challenging endeavor. What must be addressed are complex financial, institutional, legal, and even psychological relationships among the major institutions in that country. Almost by definition, these are the institutions that could pose systemic risk and that are likely to be seeking ways to reduce or manage such risk. The central bank, large financial institutions, large users of payments, the courts, and the government must all be involved.

Cross-Border Payments

While progress is being made in some countries to address systemic risk, cross-border payments represent the last frontier, the last major payment area in which the practice basically has been "everyone for himself." Clearing and settlement are still, by and large, bilateral between banks in different countries; traditional credit appraisal and the two legs of foreign exchange transactions are handled separately in each bank. Some multilateral netting arrangements are functioning for foreign exchange transactions, but much remains to be done before systems such as Multinet or the European Clearing House Organization (multilateral, multicurrency netting arrangements that are being developed by groups of commercial banks) are fully operational.

The magnitude of the task of obtaining a degree of legal certainty for cross-border payments will be very great, because the goal will be to give special treatment to certain transactions while limiting within each country the jurisdiction of the court and the powers of the government to intervene in the case of insolvent or bankrupt parties.

There are a few questions concerning the way to increase legal certainty for cross-bank payments. Practically, should countries move toward the goal by making treaties or by enacting legislation? Should each case be considered separately in the context of a specific system or proposal? What are the precedents for such legislation or treaties governing a broad set of jurisdictions and commercial activities? Is it necessary to break new ground?

Legal aspects of netting mainly concern bankruptcy and insolvency, but a legal framework can influence incentives and behavior on the part of banks and other users of payments before these events occur. In each country, the large-value transfer system is at the heart of multiple and complex relationships among the various parties. In particular, the commercial banks have specific expectations of what the central bank will or will not do in the event of a crisis. These expectations can influence significantly their actions in regard to risk management: if assistance is expected, less attention may be paid to payment system risks. These expectations may be influenced by the pronouncements of the central bank and thus depend critically on its credibility. At the end of the day, experience has the most powerful impact. However, systemic crises are rare, so that it is only infrequently that the central bank will be able to demonstrate its resolve to act or not to act. From country to country, central banks are likely to have different perceptions of the amount of systemic risk present in a given crisis and even of the role that they should play. In moving toward a more homogeneous treatment of cross-border payments, such deeply rooted national differences will need to be taken into account.

Chapter 26 Securities Transfers

26A. Delivery Against Payment

ERNEST PATRIKIS

Introduction

If a person is going to give up something of value, what is to ensure that something of value will be received in return? This exchange occurs familiarly in *trade transactions*. A person giving up goods for money wants to make sure that the money will be received. A letter of credit, with documents attached, can be used to accomplish the transaction. In the past, the seller[1] in a *securities transaction* would give the securities with a demand draft attached to a messenger. The messenger would walk to the buyer's firm and present the demand draft with the attached securities for payment. The buyer would try to ascertain whether the securities were genuine; if they were, the buyer paid with a certified check (a check that had been stamped as certified by a bank, resulting in the debiting of the buyer's account by the bank). Consequently, the seller had the bank's obligation, not the buyer's. If the buyer could not pay for the securities, the messenger would return with them. In those transactions, therefore, there would only be delivery against payment (that is, the certified check).

Frequently, when the buyer would go to the bank and ask for the check to be certified, there would be insufficient funds in the buyer's account. The bank would make a day loan to the buyer. The interest rate paid on the day loan was really more in the nature of a transaction fee, because the bank felt that the loan backed by the securities had a fairly low risk and was confident that it would be paid off later in the day. The transaction was booked as a loan and not handled as an overdraft in the account because an archaic U.S. law made it a crime for a bank to certify a check when there were insufficient funds in the customer's account. With the overdraft programs that exist today, however, the situation is quite different.

This procedure worked fairly well until the securities market in the United States took off in the 1960s. The back rooms of the securities firms were unable to process the securities transactions in a timely fashion. This inability created "fails," that is, failures to deliver and failures to

receive. It also created risk. If customers of a buyer's firm paid their funds to the buyer but the securities were not delivered to the buyer and the buyer went bankrupt, the customers became unsecured creditors of a failed securities firm. The customers had made their payments but did not have delivery against payment. In the 1960s, a number of small firms that were unable or unwilling to make the investments in their backroom systems needed to keep current with the times did fail, and others were merged out of existence.

This process is analogous to what is occurring today. The concern now, however, is not with the backroom processing of trades; it is with risk management. Today, the issue is derivatives. Are funds being put into systems that manage risk? Those firms that do not invest in risk-management controls will go the same way as those firms that did not invest in their back rooms in the 1960s.

The problem that arose in the 1960s was addressed by changing from the old system of delivery against payment via messengers to delivery versus payment (DVP) systems. Also, the concepts of immobilized security (the security does not move; it stays in one place) and true book-entry security (the uncertificated security) were introduced. In the United States, a large number of people invest in mutual funds, which, in turn, invest in stocks and bonds. In contrast, people in the 1960s more often invested directly in stocks. Investors in mutual funds send their payments to those funds and receive in return advices in the mail. They do not get share certificates representing units in the mutual funds. (A number of these mutual funds are corporations.) The fact that there are no pieces of paper that investors can redeem by having the mutual funds, in effect, buy back their shares does not bother investors. Therefore, the question of whether individuals will be willing to forgo a physical piece of paper is answered by the broad acceptance today of this form of book-entry interest. This acceptance should help the transition to a full book-entry system.

Types of Delivery Against Payment

There are different types of DVP systems. A report on DVP in securities settlement systems prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries concluded that the securities transfer systems in use or under development in the Group of Ten countries could be classified as follows:

Model 1: systems that settle transfer instructions for both securities and funds on a trade-by-trade (gross) basis, with final (unconditional) transfer of securities from the seller to the buyer (delivery) occur-

ring at the same time as final transfer of funds from the buyer to the seller (payment);

Model 2: systems that settle securities transfer instructions on a gross basis with final transfer of securities from the seller to the buyer (delivery) occurring throughout the processing cycle, but settle funds transfer instructions on a net basis, with final transfer of funds from the buyer to the seller (payment) occurring at the end of the processing cycle;

Model 3: systems that settle transfer instructions for both securities and funds on a net basis, with final transfers of both securities and funds occurring at the end of the processing cycle.[2]

However, I would like to suggest a more colloquial classification of DVP systems based on systems that are actually in use.

First DVP System: Dummy Entry System

The first system in my classification is the *eo instanti* or dummy entry system. In this system, messages requesting the transfer of securities against payment go back and forth over the telecommunications system between all the participants during the day. The central facility is a computer that holds the securities in the funds accounts of the parties. The entries during the day are not real entries representing debits and credits to accounts. Although the entries may result at the end of the processing cycle in debits and credits to accounts, rights and obligations do not change hands between those parties during the day as the messages go back and forth. In the United States, the system of The Depository Trust Company handles the bulk of the equity securities transfers in this way. In Europe, sellers of Eurobonds may use Euroclear to transfer the securities to the buyer; although the Euroclear computer appears to be debiting and crediting, the actual debiting and crediting of accounts happens only after Euroclear closes for the day. A fail in these systems (which can occur if someone is unable to transfer securities or if there are insufficient funds) does not constitute a revocation of the transfer. There is thus no concern about parties having rights that may need to be revoked.

A dummy entry system can, however, have other features built into it. Such a system can decide if the seller is short (that is, does not have) the security. It may arrange to have the security lent to the seller, so that the seller will be able to transfer the security upon final settlement. Similarly, if its calculations suggest that the buyer will not have sufficient funds, the system can arrange a loan for the buyer, perhaps secured by the security to be delivered. Again, however, rights and duties are recorded only after the close of the cycle.

Second DVP System

Operationally, the second DVP system looks almost the same as the first. The seller sends the security against payment across the system. The seller's securities account is debited; the seller's funds account is credited. There is a question, however, of whether the buyer's funds account is debited. An intermediary (typically, a trust company in the United States, although it could also be an ordinary corporation) may hold the securities and funds accounts. However, in this second system (in contrast to the first system described above), the funds credits and securities debits to the seller, or transferor, are real credits and debits. The transferor no longer legally has the security, as of the moment that the security is sent against payment across the system. These debits and credits go back and forth in the system during the day. There may be a net settlement at the end of the cycle, which implies that the system is constantly netting the positions in funds and securities accounts. At the end of the day, parties come up as net debtors or net creditors.

These two DVP systems are closed with respect to securities. In other words, securities overdrafts should not occur. Securities should be immobilized, and book-entry security should be in place. The only overdrafts that ought to occur are in respect of funds. However, when both of these systems settle, some parties are net debtors, and some are net creditors. In these systems, how are payments made by net debtors to net creditors? In the United States, these payments are typically made through Fedwire transfers by the net debtors to the system's account at the Federal Reserve Bank of New York. Payments are then made back out to the net creditors. One concern in this respect is that making settlement payments through a system that is itself a net settlement system could pose too much of a systemic risk. Should a system, such as the same-day settlement system of The Depository Trust Company or the Participants Trust Company system, be allowed to settle by having the funds transferred through a settlement system that is provisional? The simplistic answer is no, of course not; there are just too much provisionality and too much risk in these systems. Of course, the matter is not that simple.

The Federal Reserve has some concerns about this second type of DVP system that are similar to the concerns that it expressed about the Clearing House Interbank Payments System (CHIPS). Arguably, the system must have arrangements in place to ensure settlement at the end of the day, in order to limit the systemic risk. If a large seller of securities (and a large net creditor) is told at 6 p.m. U.S. eastern standard time that the system is not working well, its counterparty has collapsed, and it will not get its $1 billion, what will the seller do? Does the seller have an interest in the securities? Can the seller pledge the securities? Can the seller

raise $1 billion? If the seller is going to be $1 billion short someplace, will that start the falling domino effect that can give rise to systemic risk? It is thus the inability of participants to get liquidity in the market late in the day that generates the greatest concern.

Consequently, the Federal Reserve insists that these systems have their own liquidity facilities. Sometimes the securities cannot be delivered because a party cannot pay. This outcome does not always result from a major failure; it may merely be a mistake—for example, if a party cannot get its funds in on time or the transfer is sent to the wrong place. A system like that of the Participants Trust Company has the capability of taking the securities that it cannot deliver, pledging them overnight to a bank, and obtaining the necessary funds to allow settlement. If a participant were to fail, arrangements would be made the next day to unwind or liquidate the securities or otherwise deal with the problem.

The Federal Reserve insists on the establishment of liquidity facilities partly because the world does not stop turning. If problems in the United States cannot be cured by nightfall, the situation could start to affect the markets in the Far East, as the same group of parties deal and settle with each other all over the world. The cost to these systems is that of setting up the necessary controls and financing arrangements to ensure settlement.

Third DVP System: Central Gilts Office Net Settlement System

The third type of DVP system is the net settlement system of the Central Gilts Office in the United Kingdom. This system seems to be based on the assumption that U.K. clearing banks never fail. The seller delivers the securities to the buyer, but the funds for every delivery are really owed by the buyer's bank. The buyer's bank takes a security interest in the securities, just as if the securities were delivered to the buyer's bank and held there in safekeeping during the day as collateral for the loan. There is an assured means of settlement in this system because the bank will always settle. When the buyer pays the bank by the end of the day, the bank gives up the interest in the securities.

Fedwire: A Real-Time Gross Settlement System

In the United States, the real-time gross settlement system is also used as a DVP system. Fedwire provides for securities against payment for federal government securities issued by the Treasury Department, as well as for Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association securities. Today, the Federal Reserve has as customers only depository

institutions, the Federal Government, international organizations, and foreign central banks and governments, but perhaps someday securities dealers will be added. In a transaction, the Federal Reserve Bank of New York, following the seller's instructions, debits its book-entry securities account and credits its funds account. The reverse is done to the buyer's accounts: a debit is made to the buyer's funds account and a credit is made to the securities account. These entries typically take about one second to accomplish.

As many as $500 billion transfers are recorded each day on the books of the Federal Reserve Bank of New York. The U.S. government securities market is the largest securities market in the world, dwarfing the New York Stock Exchange in terms of volume of financing activity. The debits and credits that are made by Fedwire transactions are final. Accordingly, the transfer is not revoked if the right security is sent to the wrong bank or the wrong security sent to the right bank, resulting in the return of the security. Corrections are made by separate transfers.

Much credit is extended through daylight overdrafts in the working of the real-time gross settlement system. The Federal Reserve Bank does not insist that the buyer have funds in its account before the Reserve Bank delivers the security. Therefore, it is not uncommon for banks, especially the larger clearing banks, to have overdrafts with the Federal Reserve of $1 billion–$12 billion during the day. The banks' positions are supposed to be adjusted to zero by the end of the day because the system is intended to afford a daylight overdraft facility. Typically, peaks in buyers' overdrafts during the day will be reduced as the securities are retransferred to other buyers.

Originally, the Federal Reserve Bank did not have a daylight overdraft program. However, the Bank of New York, one of the largest clearing banks, had a software problem one day. Participants could send securities to the Bank of New York, but it could not send the securities out. When the system was shut down that night, the Bank of New York owed $23.4 million to the Federal Reserve Bank of New York. A security agreement was prepared, in which the Bank of New York repledged those securities, plus the rest of its domestic bank assets (everything that the bank owned in the United States), to the Federal Reserve Bank of New York. The Bank of New York repaid the Federal Reserve Bank of New York the loan the next day with interest.

This incident provided an impetus to the development of the daylight overdraft program. Changing its ways of operation, the Federal Reserve Bank of New York has entered into security agreements with the major clearing banks that typically occasion large daylight overdrafts. In accordance with such agreements, the Federal Reserve Bank of New York takes

a security interest when government securities are delivered against an inadequate balance. If the financial condition of the bank involved is sufficiently weak to arouse the concern of the Federal Reserve Bank of New York, it may reject a transaction that would otherwise give rise to a daylight overdraft, and there will be no delivery. However, this happens only very rarely.

Other DVP Systems: Trade Confirmation and Trade Netting Systems

Two other DVP systems are also noteworthy. The first is the trade confirmation system. One way of ensuring that the right security is delivered to the right party in a DVP is for the buyer and the seller each to send confirmations to a central computer that will match the terms and the securities. The parties will then know they have dealt with the right security. This system helps eliminate the number of "don't know" transactions, in which the wrong security is delivered to the right person or the right security to the wrong person.

The second system, which can be a part of the trade matching system, is the trade netting system. This system can accommodate a market such as the government mortgage-backed security market, in which all trades in one security over a number of days may settle on the same forward date. If the bank keeps only the gross number of trades, it will look as if it has a huge exposure in its books; however, if the bank can set up a system in which those trades are netted with its counterparties, its exposure will to be reduced to the net amount.

26B. Legal Issues Regarding Payment and Settlement

MARYSUE FISHER

Central banks have a natural interest in understanding and improving existing mechanisms for completion of securities transfers. The Group of Ten central banks decided that a comparative study of these mechanisms would yield the greatest benefits and commissioned two separate studies of securities transfer systems. The first was the delivery versus payment study, which focused on direct participation in national settlement systems.[1] The second study focused on cross-border security settlements and addressed some of the more basic issues that were put aside in looking at the delivery versus payment issues, including the role of intermediaries in securities transfers and the legal relationships underlying the choices that people make when choosing a settlement mechanism.[2] The conclusion reached by the cross-border study group in the legal area was that "[t]he most significant legal distinction between a domestic and a cross-border securities transaction is the potential for issues related to 'choice of law' and 'conflicts of laws'."[3] Stated as a formula, a domestic settlement plus conflicts of laws equals a cross-border settlement.

Domestic Settlement Issues

Technology has taken control of electronic settlement systems and the linkages that now exist among national settlement systems. This development has obscured some of the basic legal issues, which still deserve study. The investor is trying to acquire an interest in a security, which is a performance obligation of the issuer of the security; the object of the investor is to ensure that the performance is received.

The problem today is that almost all securities transactions occur through intermediaries. As each intermediary is added to the process, new legal relationships are created. At each level, there are the same layers of risk, including insolvency, the possibility that the intermediary will act negligently, and the possibility that employees of the intermediary will commit fraud. The goals of these transactions for the issuer and the investor remain the same. The issuer seeks the discharge of its obligations on the security, whereas the investor seeks to receive the issuer's performance. Through the use of these intermediaries, however, the issuer risks that, despite the performance that it makes, its payment will somehow be diverted. The investor also risks that, somewhere along the way, the investment will be turned to other uses.

It is easy to classify many of the layers of intermediaries as agents of the various parties. The issuers' agents include the registrars for transfer and the paying agents. Investors pick their money managers, brokers, and custodians. However, at the heart of modern securities markets are mechanisms that cannot easily be classified as acting for one or another of the parties. These are the exchanges, centralized market mechanisms for trading, clearing corporations, and central securities depositories. These mechanisms provide very specialized services for large groups of investors and market participants. In many respects, they resemble public utilities, as they provide services to these parties on a similar basis. However, if a problem develops in one of these mechanisms, it is not easy to say for which party the mechanism was acting in assigning risk of loss in individual transactions.

The problem for issuers and investors is that they have no choice about the mechanisms that will be used. Often, the mechanisms are prescribed by regulatory bodies. Certainly, active market participants—brokers, dealers, and large banks—desire to use the most efficient and least costly means of providing settlements. Consequently, those who want the performance to be complete—the issuers and the investors—have no control over the activities of the intermediaries (the layers between the issuer and the investor) that affect their own legal relationships. In fact, the number of intermediaries involved can multiply without the knowledge of the people who are most directly affected.

Although the legal relationships that arise can be unclear, these modern market mechanisms are essential. Paper-based settlements of securities are increasingly rare. Paper restricts the volume of transactions, causes delays, and increases the risk. It is very difficult to achieve a delivery versus payment with paper securities. The less time between the exchange of the security and the exchange of the payment, the less risk there is in the transaction. However, it is a real challenge to create book-entry securities that embody the rights that were previously embodied in pieces of paper without at the same time creating new risks.

A Group of Thirty study on this issue[4] has increased the pressure in world markets to eliminate paper securities. The shift to a uniform settlement of "trade date plus three days" has spurred the development of new mechanisms that will avoid physical settlements of securities. Obviously, these electronic settlement systems are here to stay, and intermediaries will be involved in almost every aspect of securities transactions.

Cross-Border Settlement Issues

In a cross-border environment, the issues that arise in securities systems are compounded by questions of choice and conflict of laws. It is very difficult for investors to protect themselves from risk when they do not know which intermediary is involved, where it is located, and what country may claim jurisdiction over the transaction.

The Group of Ten central banks have done much to explain how payments can be processed efficiently with the lowest level of risk. The problem with applying these concepts to securities transactions is that the laws underlying securities tend to be more idiosyncratic. There are very large differences from country to country in schemes affecting the ownership, transfer, and pledging of securities.

Countries have used various methods to ease the transition from paper-based settlements to electronic-based settlements. Book-entry securities can be fitted into two different types of schemes. Under the first type of scheme, book entries are fitted into a country's existing legal regime for physical securities. Often, this is accomplished through legal fictions and the immobilization of physical securities, upon which book-entry systems are then imposed.

Other countries have used the second type of scheme, which explicitly recognizes electronic securities. However, these schemes can take very different forms; even though systems may look the same, different legal relationships can arise. Some of these schemes attempt to preserve the individual identity of the security, while others specify that book-entry securities are essentially fungible and create new forms of property interest in those securities. Securities may be owned by all of the holders in a single system on a co-ownership basis with a proportional property interest, or there may be no specific property interest at all. Also, the relationship that arises may be a debtor-creditor relationship; if so, the security may be analogous to a bank deposit with special performance characteristics. Under that kind of scheme, it may almost be fair to call the instruments derivatives rather than securities.

The schemes can also be refined further. The interests in a debtor-creditor system can be secured by the particular securities that the investor is seeking to buy, or the scheme can create a preferred class of creditors secured by all of the securities that are held in the depository.

There are probably 50 different securitization schemes in use today, but the variety of legal approaches to the same question is obscured by the trading and settlement mechanisms that are used to create the interests. For example, country A may still use a paper-based legal system

while country B has a dematerialized (electronic-based) system of some sort. If the central securities depository holding the securities of country A and country B is located in country A, there is a serious question about what investors get when they acquire country B securities. If country A does not recognize the country B electronic securities as securities—even though they are maintained on the same system as paper securities recognized by country A—investors in the country B securities held in country A may get a very different package of rights from investors in the same securities held in country B. This may sound like an issue that is not very common; in fact, however, as the linkages among national settlement systems become more common and the barriers to foreign participation in domestic markets become lower, as in the European Community, the risks of these problems will rise. One of the findings of the study of cross-border securities settlement cited above[5] is that a large number of these linkages already exist. For example, there are more than 30 linkages alone among the Group of Ten countries. Some of these mechanisms are, of course, more active than others.

The shift from paper to book-entry securities has challenged those charged with overseeing domestic market activity. The goals were very simple in the past: count the securities and examine the vault procedures. The supervisor could be reasonably certain that the securities corresponded to the accounts held by the bank. Now, the process is one of reconcilement. The supervisor looks at the bank's electronic records and determines whether they correspond to the electronic records of the bank's intermediary. However, there is no way to verify independently that those electronic accounts anywhere equal the obligations issued by the issuer.

This is an area in which supervisors and central banks will need to do additional work. Even in systems in which property interests still arise when securities are turned into electronic forms, the supervisors may not be equipped to monitor that activity differently from debtor-creditor relationships in bank accounts.

Questions relating to the insolvency of intermediaries become more complex in the international environment. If an intermediary in country A becomes insolvent while holding securities for customers in different countries, there will be much dislocation as investors try to determine what law applies to their rights in the insolvency.

A number of countries have in recent years enacted new laws to minimize the complexities that arise in bankruptcy. In particular, all of the countries in the Group of Ten that had zero-hour bankruptcy rules have eliminated or narrowed the scope of them. These rules determined that a bankruptcy dated back to the beginning of the day of bankruptcy, so

that all activity happening on the day of the bankruptcy actually counted for nothing. For settlement systems, this was critical because an insolvency occurring after the close of a settlement system but before midnight negated the activity of that day with respect to the insolvent participant.

It is unlikely that all countries' laws on the transfer, pledging, and ownership of securities will be harmonized any time soon. However, predictability of outcome is still essential to make these markets work. Banks, investors, and supervisors must try to understand where the legal relationships arise and attempt to identify what law governs those relationships. If parties to transactions can identify all of the layers of intermediaries that affect their rights, the risks can in theory be assigned and compensated. However, it is essential, as a starting point, to determine the laws that will govern the relationships that concern the parties.

Most law that applies to these relationships is contractual, coming from agreements, market conventions, rules of self-regulatory organizations, and trade associations. However, the most complex form of agreement is the multilateral relationships that are created in the central market mechanisms, largely through those mechanisms' rules. Direct participation is often limited, and, even though the rules may affect the rights of parties who are not participants, such as issuers and investors, those rights are rarely acknowledged. Consequently, if there is one thing that must be done, it is to identify—no matter how difficult the task—the intermediaries involved in securities transactions, as well as the countries asserting jurisdiction over those intermediaries and the claims that arise from their activities.

26C. Securities Clearance and Settlement

SIMON M. LORNE

The Importance of Securities Clearance and Settlement

Two stories illustrate why securities clearance and settlement should be of interest to central banks, as well as to securities regulators. They demonstrate that problems in these areas, if not promptly and satisfactorily resolved, may cause problems for a country's whole financial system.

Hong Kong

The first story is set in Hong Kong in October 1987. The Hong Kong stock market, like many others around the world, was booming. Trading was active not only in equities but also in a relatively new instrument, futures on the Hang Seng index. Many local individual investors were betting that the market would continue to rise and were thus long in futures. Foreign institutional investors were generally short in futures, hedging their stock portfolios. Trading in these futures contracts was so active that, in terms of the number of contracts traded, volume in Hong Kong was second only to volume in Chicago.

On Monday, October 19, the Hang Seng Index declined by 11 percent. Later that day, the Dow Jones industrial average fell by an amazing 22 percent. When this news reached Hong Kong, early in the morning of Tuesday, October 20, the Hong Kong Stock Exchange decided to close for the remainder of the week. One reason that the stock exchange cited for closing was the large backlog of unsettled share trades. (Settlement at that time was done trade by trade, between brokers, by delivery of a share certificate against a check. Delays and backlogs were common.) Many believed, however, that the real reason that the stock exchange closed was to attempt to save the local Chinese investors from financial ruin in the futures exchange.

Many of these Chinese investors, who were long in futures, did not pay the margin calls that they received on October 19–20. In turn, many of the futures brokerage firms, small firms without much capital, did not pay the margin that they owed to the futures clearinghouse. Thus, the clearinghouse could not pay what it owed to brokers, who were generally short in the futures market. The guarantee corporation set up to guarantee futures contracts had less than $3 million in capital. This corporation

could not call upon the healthy firms for additional capital, just as they, apparently, could not call directly upon the guarantee.

On the morning of October 21, the Government, exchanges, major banks, and brokers met to discuss the problem. Some suggested that the problem could be solved by "closing out" all the outstanding futures contracts at the last price on October 19. Others pointed out that this action would force the foreign institutions to close out by sale their positions in the stock market, which would lead to a collapse in the stock market and probably to serious adverse effects for Hong Kong's currency and economy.

After several days of discussion, a "rescue package" was agreed to late on Sunday, October 25. The package included a $250 million loan to the guarantee corporation: half of it from the Hong Kong Government's exchange fund and half of it from major banks and brokers. Although this was called a loan, to be repaid out of transaction fees and collections from defaulting brokers, it was not at all clear on October 25 that it would be repaid.

It was also not clear whether $250 million would be sufficient to satisfy the guarantee corporation's obligations and to allow the futures market to continue. Indeed the next day, October 26, the Hong Kong stock market declined by 33 percent, making it necessary to arrange another $250 million standby facility for the guarantee corporation. It was only on October 27 that the market "found its feet" and recovered by 7 percent. It was many months, however, before there was any significant volume of trading in the futures contract.[1]

New York

The second story is set in New York in February 1990. On February 13, 1990, the Drexel Burnham Lambert Group (Drexel) announced that it would file a bankruptcy petition. The announcement emphasized, however, that the bankruptcy petition would not cover Drexel's broker-dealer or government securities subsidiaries. Later in the day, the Securities and Exchange Commission (SEC) announced that, according to Drexel's books, the broker-dealer subsidiary still had a positive net worth and was still in compliance with the SEC's net capital rule. The Federal Reserve Bank of New York announced simultaneously that Drexel's government securities subsidiary remained a primary dealer in good standing in the government securities market.

At this point, the SEC, the Federal Reserve, and Drexel all wanted to see an orderly liquidation of Drexel's securities portfolio and an orderly

transfer of its customer accounts to other firms. This process, however, was hindered by problems in the clearance and settlement system.

Drexel had pledged much of its securities portfolio to its lender banks; accordingly, it needed to obtain releases of this collateral from its banks to deliver securities in settlement. Drexel's banks, however, were unwilling to release the collateral. Indeed, in part because of legal uncertainty about the effect of a pledge on Drexel's books, many of Drexel's banks insisted that Drexel start to record pledges on the books of The Depository Trust Company. This demand made it essentially impossible for Drexel to settle its securities trades, many of which were liquidating trades, in the normal way.

A similar problem occurred with Drexel's portfolio of mortgage-backed securities. In 1990, trades in certain types of mortgage-backed securities settled only once a month, through delivery of a certificate in return for a wire transfer later in the day. However, on February 14, 1990—the day after Drexel filed for bankruptcy—$3.3 billion worth of trades between Drexel and other government securities dealers did not settle. In part, this was because few firms had provided Drexel with the standard two-day notice as to what securities they would deliver to Drexel on February 14. Also, firms were unwilling to follow the standard practice of delivering a negotiable certificate to Drexel in return for a wire transfer later in the day.

These problems created serious risks that Drexel's financial difficulties would cause financial difficulties for other securities firms. They also raised the prospect of "financial gridlock," with no bank or securities firm willing to extend customary credit to any other firm, for fear that it, like Drexel, was about to file for bankruptcy.

Fortunately, Drexel, the banks, the brokers, the SEC, and the Federal Reserve were able to work out the problems. The problem of the pledged securities was solved by an agreement among Drexel and its banks on February 19, 1990. This agreement allowed for settlement of approximately $260 million in liquidation transactions, segregation of $40 million in customers securities that were fully paid for, and reduction of the outstanding loans to the banks through the proceeds of these transactions. The problem of the mortgage-backed securities was solved when Goldman Sachs purchased Drexel's entire mortgage-backed securities portfolio. Goldman Sachs then settled the failed settlements and liquidated the portfolio.[2]

Reducing the Risks Involved in Securities Clearance and Settlement

These stories illustrate that the legal and practical aspects of securities clearance and settlement are important. What, however, can be done to reduce the risks involved in the securities clearance and settlement system? In particular, what can be done to reduce the risk that problems in the securities clearance and settlement system will cause problems for a country's whole financial system?

Unfortunately, there is no simple answer or set of answers. Perhaps the closest thing to an agreed agenda is the March 1989 report of the Group of Thirty, with its nine recommendations for strengthening securities clearance and settlement systems.[3] Each of these recommendations, however, raises its own issues, many of which are specific to the practices or laws of a particular country. Rather than attempt a catalog of issues, one can focus on three issues that seem both significant and universal: shortening the settlement cycle, demobilizing or dematerializing securities, and creating or improving netting transactions.

Shortening the Settlement Period

One way to reduce the risk in the clearance and settlement system is to shorten the settlement period (the period between trade date and settlement date). A shorter settlement cycle reduces the number of trades that, at any one time, are still outstanding and unsettled; it also tends to reduce the disparity between the trade price and the price on the settlement date, which, in turn, reduces market risk. The National Securities Clearing Corporation, the major clearinghouse for equity securities in the United States, estimated in 1992 that moving from the then current five-day settlement cycle to a three-day settlement cycle would reduce the National Securities Clearing Corporation's market risk by almost $200 million in the event of a failure of a major securities firm during a market crisis.[4]

A shorter settlement cycle, however, has costs. In the United States, some securities firms fear that a shorter cycle would make it impossible for customers to buy securities in the way that many normally do: by placing their order by telephone, receiving a confirmation by mail, and then sending a check by mail. Meanwhile, some securities customers are concerned that a shorter settlement cycle would make it impossible for them to hold securities in the way that they normally do, in physical certificates at their banks. Others point out, however, that there are ways around these problems. Customers could deposit funds with brokers before plac-

ing buy orders or return the certificates to the broker before placing sell orders.

The SEC resolved this issue through a compromise: it arranged for a long transition to a shorter settlement cycle. The SEC rule establishes three business days as the standard settlement cycle for equity securities transactions in the United States.[5] The rule, however, did not take effect until June 1995.[6] The SEC explained that the long transition period would allow for both the development of new systems and, perhaps more important, for the education of participants and customers about the rule and systems.[7]

Demobilizing or Dematerializing Securities

A second way to strengthen the settlement system is to "demobilize" or dematerialize securities. The demobilization of securities is somewhat different from the demobilization of an army. In the case of an army, demobilization takes people who are organized in military units and sends them to their separate homes. In the case of securities, demobilization takes securities certificates that are spread around the country and brings them into one home, a central securities depository. It is sometimes described, perhaps more aptly, as "immobilization."

Once securities are in a depository, they can be transferred or pledged by entries on the books of the depository. This simplifies true delivery against payment, in which electronic payment and delivery occur simultaneously. Demobilization also reduces the risks involved in the physical transfer of securities certificates. If thousands of securities certificates are delivered or mailed every day, some of them will be lost or stolen. However, demobilization also creates some new issues. For example, it is often necessary to amend the relevant commercial code to address the transfer or pledge of securities that are on deposit and thus cannot be delivered in the traditional sense. In the United States, revisions to the Uniform Commercial Code have been drafted in order to accommodate the transferring or pledging of dematerialized securities.[8]

"Dematerialization" is not confined to science fiction; in the securities markets, it is the process of moving from paper securities certificates to electronic records of securities ownership. Dematerialization allows securities to be transferred by electronic entries on the books of the issuer or its agent. In the United States, for example, most U.S. treasury securities are issued only in "book-entry" form; there is no certificate, only a record of ownership on the books of the Federal Reserve Bank of New York. Mutual fund shares are also issued only in book-entry form; investors receive statements only, and not certificates.

Although many individual investors in the United States own one or more of these "uncertificated" securities, some individual investors still want the ability to obtain physical certificates for their common stock. In moving to a three-day settlement cycle, the SEC has reassured investors that three-day settlement will not make it impossible for them to obtain share certificates. One of the great strengths of the U.S. equity market is the active participation of individuals—over 50 million at last count. The SEC wants to encourage individual participation in the market, but it also wants to create a settlement system that is safe for all participants.

Netting Systems

A third way to strengthen the clearance and settlement system is to create or improve netting systems. The simplest form of netting is bilateral. Rather than settle each securities trade separately, two firms net all their trades in each security, so that one of them delivers to the other only the net position in the security. The firms also net their obligations to deliver funds, so that rather than exchanging large sums, one firm delivers a comparatively small net sum.

Bilateral netting among firms reduces the number of securities and funds transfers, but it still requires daily transfers among all the active firms. Many securities markets now use continuous net settlement, through a central clearinghouse, to reduce the number and increase the security of transfers. In a continuous net settlement system, each firm's obligation to each other firm becomes, at some defined point, an obligation to the clearinghouse. The clearinghouse continuously nets all these obligations; each day, it transfers to, or receives from, each firm a net amount of each security. The clearinghouse also transfers to, or receives from, each firm the net amount of cash due daily or more frequently.

Continuous net settlement solves many problems but raises others. For example, transforming obligations among firms to obligations between firms and a clearinghouse eliminates the need for firms to assess the credit of each of their counterparties. However, it makes it imperative, as the Hong Kong experience demonstrates, that the clearinghouse itself have unquestionable credit. It also becomes imperative that the clearinghouse have adequate information about the creditworthiness of its member firms. The proliferation of products, markets, and clearinghouses may make this difficult. The National Securities Clearing Corporation, for example, may have complete information about a member firm's positions in U.S. equity securities but little or no information about its positions in overseas equities or over-the-counter (OTC) derivatives.

Derivatives show why the task of strengthening the clearance and settlement system never ends. Although the instruments themselves are often quite complex, the settlement system for OTC derivative transactions is quite primitive. Transactions settle firm by firm, often transaction by transaction, through fund and in some cases securities transfers. This means, as many have pointed out, that participants may use OTC derivatives to reduce market risks, such as the risk of a shift in two interest rates; however, this benefit often comes at the cost of increased credit risk, namely, the risk that the counterparty will fail between the initiation and the end of the interest rate swap agreement. Clearly, as the OTC market continues to grow, participants and regulators need to focus on improving the clearance and settlement system for this market. Two areas to consider are the standardization of agreements and the creation of netting arrangements.

Conclusion

The securities clearance and settlement system is important to both securities regulators and central bankers. The issues involved in improving the clearance and settlement system are not only practical but also legal. Lawyers are important in this process because good lawyers raise the unpleasant hypothetical questions that must be raised and answered to improve the clearance and settlement system. The issues involved also have a political dimension: the costs of improving the securities clearance and settlement system are often immediate and concentrated, while the benefits of such improvements may seem distant and diffuse. Securities regulators and central banks must be involved in these political issues. Without disregarding the costs involved in improving the clearance and settlement system and without overstating the risks, regulators and bankers must work together to improve the clearance and settlement system and to educate the public and interested parties about it.

COMMENT

CHARLES W. MOONEY, JR.

This comment addresses (i) the project in the United States for the reform of private law concerning the transfer of interests in investment property, such as securities, and (ii) how reform and harmonization of this area of the law might be addressed on the international level.

U.S. Rules for Transferring Security Interests in Investment Securities

The sponsors of the Uniform Commercial Code (UCC) promulgated a revised version of UCC Article 8 (Revised Article 8) in 1994, accompanied by related revisions of Article 9.[1] Revised Article 8 and the related Article 9 revisions, dealing with security interests in investment securities, came before the membership of the American Law Institute at its annual meeting in May 1994; the revisions also came before the membership of the National Conference of Commissioners on Uniform State Laws in August 1994.[2]

For several reasons, the drafting committee faced an enormous challenge in undertaking this private law reform project. Revised Article 8 codifies the private law for a type of property that the current law addresses only obliquely—claims to securities controlled by an intermediary, such as a broker or bank. The principal goal of revised Article 8 is thus to provide a new legal framework for the indirect holding system that has developed in this country.

In the United States today, most publicly traded shares on the exchanges and the over-the-counter market are held in a nominee name used by The Depository Trust Company. This company acts as a depository, holding physical securities for the benefit of some 600 participating broker-dealers and banks. The use of this common depository eliminates the need for physical deliveries between these parties incident to their trading activities. Entries are made on the depository's books for net changes in the positions of each participant at the end of each day by the National Securities Clearing Corporation. The broker-dealers and banks that participate in this system provide, in turn, analogous clearance and settlement functions to their own customers. This system is called the indirect holding system because the corporate issuer's records do not show the identity of the beneficial owners of the securities. Instead, a sub-

stantial part of the outstanding securities of a given issue are recorded by the issuer as belonging to a depository, the records of the depository show the identity of the banks and brokers, and the records of these securities intermediaries show the identity of their customers. The advantages of the system include the elimination of the need for physical deliveries of securities and, as a consequence of the netting of transactions between participants, a significant reduction in the number of entries that would have to be made on the depository's books if each transaction between the participants had to be recorded separately.

The newly revised law deals with these complex, arcane, and constantly changing financial market systems and practices and financial assets. Moreover, these new rules, intended for enactment by the various states, are written in the presence of comprehensive federal regulatory schemes for securities intermediaries. Revised Article 8 will achieve its purposes only if it is clear and accessible both to business lawyers generally and to the experts on financial markets.

International Harmonization of Rules for Transferring Security Interests in Investment Securities

It may be suggested that rules of this sort might be appropriate for other countries that wish to improve the efficiency of their financial markets. Two general observations can be made about the prospects for the international harmonization of rules relating to investment securities. The first concerns the "who," and the second relates to the "how" and "what" of this harmonization. First, taking into account the highly specialized practices and ever-changing landscape of the financial markets, the more traditional sponsors of projects for harmonizing private international law—the United Nations Commission on International Trade Law, the International Institute for the Unification of Private Law, and the Hague Conference—are not likely candidates for sponsoring harmonization in the area of securities transfers. It was difficult enough to locate and involve the necessary expertise to pursue the Article 8 revisions in the United States. Organizations with no past involvement in the area of financial markets would probably not be up to the task.

If international harmonization of rules relating to investment securities and other investment property is to occur, the governmental regulators of the banks and securities firms in the financial markets around the world are more appropriate sponsors for the project. If a useful product were to emerge, moreover, the regulators would be well situated to encourage adoption of that product (be it a regulation, model law, or even an international convention). In this regard, the process that led to the adoption

of more uniform capital adequacy rules for banking institutions may serve as a model.

Second, as for the structure of the international harmonization of investment property rules, what product might emerge from a regulator-sponsored program of harmonization? An international convention may not be feasible or wise. It would take too long, the issues are too arcane, and absolute uniformity among states is not necessary in any event. Model laws or regulations seem more appropriate, and they would be important only in the handful of states where major financial markets are located.

As to the substance of model laws or rules, it might be appropriate to limit the scope to transactions and relationships at the "wholesale" level, that is, as among the financial intermediaries, such as banks and securities firms that deal with each other in many markets and across many borders. For example, it may not be as important to harmonize the law concerning the rights of an investor as against its bank or broker. Perhaps the more important (and realistic) approach would be to develop rules that would apply only to the relationships among the intermediaries and to their rights as against clearinghouses and depositories.

Chapter

27 International Banking Capital Standards for Market Risk: Recent Developments and Possible New Directions

JAMES V. HOUPT

This chapter addresses the emerging international capital standards, particularly the standards for market risks arising from the trading activities of banks. The basic framework under consideration for structuring new capital requirements is examined. The April 1993 proposals of the Basle Committee on Banking Supervision and some of the thoughts of the Committee regarding new standards are reviewed. The Committee was considering two risk-measurement techniques: one based on a so-called standard approach that applies risk weights to various trading positions, and another based on the results of a bank's own internal models.

Basle Capital Accord

The existing capital standard that applies to internationally active banks headquartered in many of the world's largest countries was created in late 1988 under the auspices of the Bank for International Settlements, in Basle, Switzerland.[1] That standard, known as the Basle Capital Accord, was deemed necessary by the Committee for several reasons: (i) to make regulatory capital requirements more sensitive to differences in risk profiles among banks; (ii) to introduce off-balance-sheet exposures into the assessment of capital adequacy; (iii) to minimize disincentives to holding liquid, low-risk assets; and (iv) to achieve greater consistency in the evaluation of the capital adequacy of major banks throughout the world.

In large part, the Basle Capital Accord has accomplished these goals. By design, however, it addressed only credit risk—the risk that a borrower will default on its obligation and not repay the bank. The Basle Capital Accord did not address other important risks that banks face, particularly the risks that evolving market conditions, such as changing interest rates or changes in the prices of equity instruments that banks trade, will directly and adversely affect a bank's financial strength. Consequently, soon after the Basle Capital Accord was introduced, the Committee established several working subgroups to address these acknowledged shortcomings and to enhance the standard with capital requirements for interest rate risk and for risks in trading equities and foreign exchange.

Initially, these working subgroups worked independently in their respective efforts to develop adequate capital standards that could be used by bank regulators worldwide. Although the focus was only on activities of "internationally active banks," it was recognized that the standards would likely cover far more than just the world's largest financial institutions. In some countries, many relatively small banks are considered to be internationally active because they finance international commerce and trade foreign exchange. Competitive conditions within countries have also led some regulators to extend international standards to banks with little or no truly international operations. In the United States, for example, requirements of the Basle Capital Accord have been applied to all commercial banks.

Such wide-ranging coverage and the diversity of banking industry structures among countries dissuaded the working subgroups from developing standards that only the largest and most sophisticated institutions could implement. Simple or "shorthand" rules were thought to be useful, so that banks with limited internal modeling abilities could calculate their capital requirements without investing heavily in new computer systems and additional personnel.

The first objective of the Interest Rate Risk Subgroup (IRR Subgroup) was to develop a technique for measuring the exposure of a consolidated banking institution to interest rate risk, and the subgroup made some progress toward that end. Soon, however, the subgroup's priorities were changed because of events in the European Community (EC). In order to accommodate its planned economic integration, the EC needed common capital standards for banks and securities firms, so that those two industries could compete throughout the EC on an equitable and sound basis. This pressing need of the Europeans required the IRR Subgroup to shift its attention to the trading activities of banks.

Consistent with that purpose, the work on traded equities and foreign exchange was transferred to the IRR Subgroup, which was also temporarily expanded to include representatives of several securities regulators. It was hoped that the Basle Committee on Banking Supervision would be able to agree with the International Organization of Securities Commissions on capital standards for trading activities of both the banking and securities industries.

In 1992, the EC, facing its own time pressures, reviewed the work in progress of the IRR Subgroup, made slight revisions to those draft documents, and adopted as European law tentative unified standards for the two industries. The resulting Capital Adequacy Directive[2] took effect at the beginning of 1996 and represents capital standards that EC banks and securities firms must meet. Subsequently, in April 1993, the Committee

issued its own (and slightly different) proposal for a public comment period that extended through the end of 1993.[3]

Initial Market Risk Proposal

The Committee's initial market risk proposal covered traded debt, equity, and foreign exchange, whether reported on or off the balance sheet.[4] It also included an important provision to expand the netting of counterparty obligations beyond that originally permitted by the Basle Capital Accord, which recognized only netting by novation.[5] This latter procedure is typically limited to foreign exchange contracts under which obligations between banks and their counterparties to deliver a given currency on a given date are combined, thus legally substituting a single amount for the previous gross obligations. The proposal permitted other forms of legally enforceable bilateral netting under specified conditions.

The consultative document of the Committee also discussed the IRR Subgroup's efforts to measure interest rate risk in the nontrading activities of a bank. This part of the document, however, is more accurately described as a status report on the working subgroup's thinking, rather than as a specific proposal. It is also viewed only as a risk measure for supervisory use, rather than as a formal capital standard.

Traded Debt

The proposal dealing with traded debt is the most complex of the April 1993 proposals. When developing this proposal, the Committee relied heavily on the concept of duration, which is a useful technique for estimating an instrument's price sensitivity to changing interest rates. This measure is determined by the timing of an instrument's principal and interest cash flows, is relatively easily calculated, and is commonly used by financial institutions and investors. In effect, it represents the *percent* change in market price for a given *percentage point* change in market rates. Duration has several important limitations and is most accurate only when estimating the effect of small market rate shifts. However, as a simple and low-cost indicator of an instrument's price sensitivity, it has significant appeal.

Using this duration technique, banks can distribute their trading assets, liabilities, and off-balance-sheet interest rate contracts (for example, interest rate swaps, futures, and forward rate agreements) among a variety of time bands on the basis of the instrument's maturity or next repricing period. The supervisor provides the duration risk weight for each time band by calculating the duration on a hypothetical instrument that has

cash flows presumably representative of the instruments that a bank will report in each time band and assuming a change in market interest rates for that band. By multiplying the amount in each time band by its risk weight, the institution can derive a total net weighted position for its entire trading account.

Stopping there, however, ignores important risks. First, the actual shifts in the market yield curve will probably never be exactly those assumed by the risk measure, so the actual changes in the market value of the trading portfolios will be different from those that were estimated. This risk is called yield curve risk. Second, opposite positions within a given time band in different instruments (for example, a long position in U.S. treasury bonds offset by a short position in corporate obligations) are not likely to respond to a given market rate change in exactly the same way. This risk is called basis risk.

The range of time within each time band presents another source of possible measurement error. The risk weight is derived by assuming that the maturities or repricing periods of the bank's instruments are distributed evenly throughout a time band and that duration risk weights can be determined by using the midpoints. In practice, however, instruments that mature or reprice at opposite ends of a time band (which can range from one to three years) could have significantly different characteristics of interest rate risk. If positions are not distributed evenly within the time band, the measure will overestimate or underestimate the risk. Finally, in the interest of minimizing the reporting burden, the Committee proposed to collect no information about an instrument's coupon. Although that information is typically less important than an instrument's maturity or next repricing period, the coupon rate affects the instrument's price sensitivity to changing market interest rates.

To address these possible measurement errors, the Committee proposed the imposition of a series of add-ons to the initial calculation of the net weighted position that have the effect of "disallowing" part of the initial netting. The details of calculating these add-ons are beyond the scope of this chapter and are somewhat complicated. They are, however, similar in concept to techniques used by some securities regulators outside the United States.

Foreign Exchange

Because some smaller institutions (especially in Europe) trade foreign exchange, the Committee developed both simple and sophisticated risk-measurement approaches. The simple approach requires capital equal to 8 percent of the sum of the larger figure of the institution's net longs or

net shorts in each currency. The sophisticated approach simulates potential losses to the institution's existing portfolio of foreign exchange positions by using the actual daily exchange rate movements experienced during the past five years (assuming a two-week holding period). The capital required should cover 95 percent of the simulated losses. It was expected that most large institutions and those with significant foreign exchange trading activities would use the sophisticated method.

Equities

The risk measure proposed by the Committee for equities addressed separately the two fundamental causes of movements in market prices: specific and general market risk. Specific risk refers to events that are relevant only to an individual firm—in this case, the issuer of the equity shares. Market risk refers to adverse effects on a company's shares in response to developments in the general market. The total capital charge for equities is the sum of the amounts assessed for the two risks.

A capital charge of 4 percent can be applied against the net position in any specific security (for example, IBM or Toyota), whether that net position is long or short. Capital is required against either net position because the trading institution can lose on both types of exposures at the same time: the share prices for which the trading institution has a net short position can rise in value, while those for which it has a net long position can decline.

General market risk, meanwhile, relates to the overall position of the portfolio, which can be either net long or net short. For this risk, the Committee proposed a capital requirement equal to 8 percent of the bank's net equity trading position.

Off-Balance-Sheet Contracts and Netting

One of the more important features of the 1988 Basle Capital Accord was its recognition of counterparty credit risk arising from off-balance-sheet transactions, such as those related to foreign exchange and interest rates. The level of credit risk arising from these types of transactions can change rapidly in response to market conditions, as a counterparty's obligation increases or declines.

In order to incorporate this fluctuating credit risk, the Basle Capital Accord requires institutions to hold capital against their current exposure arising from these transactions plus an add-on for their potential future exposure. The current exposure is equal to the market value of the contract if it is a positive value or equal to zero if the market value is zero or

negative. Current exposure represents the replacement cost that an institution would incur if its counterparty were to default. The potential future exposure is estimated by multiplying the notional value of the contract by a credit conversion factor ranging from zero to 5 percent, depending upon the type and remaining maturity of the contract; it measures the amount by which the current credit exposure may be expected to increase over the remaining life of the contract.[6]

When the original Basle Capital Accord was created, supervisors recognized that institutions, especially those actively involved in off-balance-sheet transactions as dealers, would likely have multiple contracts with the same counterparty and that the positive values of some of these contracts could be partly or entirely offset by contracts having negative market values. When the two parties to the transactions have legally binding agreements to settle their obligations on a net basis, the actual credit exposure of each institution becomes that net amount. However, because of their concerns about the legal enforceability of many netting agreements between and among counterparties, the Basle Committee recognized netting only under the limited case of novation. Institutions were encouraged to pursue other bilateral and multilateral netting agreements, but the benefits of these agreements were ignored for capital purposes.

This issue of netting relates to credit risk and is not integral to measuring market risk. The matter is, however, of substantial importance to those institutions most affected by any new market risk standards because off-balance-sheet transactions are significant to their trading activities.

For this reason, and to acknowledge and further encourage the risk-reducing use of netting agreements, the Committee addressed the issue of bilateral netting in its April 1993 market risk proposals.[7] Nevertheless, the Committee remained concerned about the ability of institutions to enforce their bilateral netting agreements in many jurisdictions. Therefore, it proposed to recognize those agreements only when the following conditions have been met:

- The bank has a legally enforceable netting agreement with its counterparty that permits the bank to receive or pay only the net value of the sum of unrealized gains or losses on the included transactions if the counterparty defaults.
- The bank has written and reasoned legal opinions stating that, in the event of a legal challenge, the courts and authorities in the relevant jurisdictions would support settlement on a net basis. In this context, if a supervisor in the home or host country of either counterparty is dissatisfied about enforceability, neither counterparty may calculate capital requirements on a net basis.

- The netting agreements do not contain so-called walkaway clauses, which permit non-defaulting parties to make only limited payments or no payment at all to the defaulter, even if the defaulter is a net creditor.[8]

Recent legislation in the United States (the Federal Deposit Insurance Corporation Improvement Act of 1991) clarified the enforceability of netting agreements between financial institutions in that country; this legislation should provide a further boost to the use of these agreements.[9] Continuing growth in these markets and the recognition of netting contracts for capital purposes may lead other countries to take similar steps in the future.

In July 1994, the Committee adopted (in substantially the same form) the April 1993 proposal on bilateral netting for the purpose of calculating current credit exposure.[10] At that time, it also issued for comment a proposal that would give limited recognition to the effects of netting agreements when calculating potential future exposure.[11]

Public Comments on the Market Risk Proposal

Although the proposal dealing with bilateral netting was strongly favored by respondents and adopted by the Committee, most other aspects of the April 1993 proposal were widely criticized. In the United States, especially, criticism was strong, as respondents urged greater use of their internal models for measuring risk. These models, they felt, offered many advantages over the proposed approach: (i) greater accuracy; (ii) greater consistency with existing risk-management techniques; and (iii) more adaptability to new products. In contrast, the proposed method would, for many institutions, be only an additional regulatory burden.

Although respondents in other countries also criticized the proposal and supported the use of the internal models, European banks, in particular, focused principally on the differences between the Committee's proposal and the Capital Adequacy Directive.[12] Nearly all of them called for standards the same as or similar to those in the directive, which—insofar as it differed from the Committee's proposal—would require less capital. This somewhat disparate response reflects the relevance of the Capital Adequacy Directive to European banks, but not to the others; it may also reflect different practices regarding internal models.

Internal Models

Beyond simply reflecting the preference of many international banks, the use of internal models has other benefits over the April 1993

proposals—not the least of which is an internal, theoretical consistency. Although the key elements of the 1993 proposal were based on empirical analysis, they also reflected multilateral compromises that were necessary to achieve an international consensus among bank regulators and that also held promise for reaching an understanding with securities regulators.

By relying heavily on historical price movements and measuring the risk in diversified portfolios consistently and systematically, internal models sidestep many of the problems created by the earlier proposals. Nevertheless, these models have their own limitations in the context of a capital standard, and supervisors need to learn more about them. In particular, the differences and similarities among the internal models need to be understood better, so that they can be incorporated into a capital measure.

This task is made more difficult because banks have designed these models for another purpose. Supervisors seek to evaluate the adequacy of a bank's capital under highly stressful market conditions, but bank managements typically use models to help them manage risks in normal times. When the risk measures show rising market volatility and, therefore, a greater likelihood for significant gains or losses, banks tend to advise their traders to reduce their open, proprietary positions. As markets calm and, especially, as trends emerge, positions are once again increased.

This focus on normal conditions and the complexity of many market risk models present obstacles that bank supervisors must overcome if they are to use models to evaluate the capital adequacy of banks. Securities regulators must also be convinced that these models can be used for capital purposes because development of a standard for both securities firms and banks remains an important objective of the Basle Committee.

Fortunately, while understanding each model's assumptions and peculiarities is important, the models of most major banks are structured in similar ways; they rely on historical price movements and use similar, although not identical, risk-measurement techniques. These similarities range from methods for measuring present values of financial instruments to techniques for estimating the price volatility of instruments with option characteristics. The latter techniques are far from simple but relatively few in number. Therefore, if supervisors can overcome these obstacles, banks could build upon their existing procedures to evaluate capital adequacy rather than be required to design new risk measures that would serve only supervisory purposes.

One of the most common practices of banks, for example, is to decompose their trading positions into a variety of risk factors that influence an

instrument's price. For this purpose, each instrument is classified in several or more ways, beginning with its major product group (for example, interest rate, foreign exchange, equity, or commodity). Long-term rates move differently from short-term rates, and currencies constantly change in value relative to one another. Therefore, information is needed about the instrument's maturity, currency, and other relevant features. A single instrument may involve only a few risk factors; however, large banks may use hundreds of these factors to manage their entire trading portfolios, depending upon the level of detail that they believe is needed to identify relevant variables and upon the nature and breadth of the instruments that they trade. By classifying and aggregating their positions by risk factors, banks can evaluate risks without constantly processing tens or hundreds of thousands of individual transactions.

Nevertheless, the specific procedures of an individual model cannot be ignored, as they can lead to significant differences in measured risk among banks. As is often said, "The devil is in the details." Therefore, both bankers and bank supervisors should have knowledge of a model's key assumptions and measurement techniques in order to understand and appropriately use the model's results. These models must also reflect similar levels of rigor if their results are to be relied upon in constructing an international capital standard. Therefore, regulators are likely to require that some elements of the risk-measuring process be standardized. The unresolved question is, What parts?

Key Parameters

Several factors, or "parameters," are especially important for the structure and output of models used by banks to measure their market risk. First, the ***historical observation period*** is used to measure the price volatility of traded products and to calculate the correlations of the price movements of instruments within and among product groups (for example, debt, equity, foreign exchange, or commodity contracts). Second, the ***confidence interval*** is needed to evaluate the model's results. Third, the ***assumed holding period*** (or "investment horizon") is relevant for each instrument. Other parameters that deal with risk-measurement techniques include (i) the manner in which the model relies upon price correlations between different product groups; (ii) the number and nature of risk factors that a model employs; and (iii) specific modeling procedures for evaluating explicit or embedded options.

One parameter that would almost surely be standardized in any supervisory framework is the holding period that banks assume. In practice, most trading banks calculate daily volatilities and assume a one-day holding period in managing their trading risks. That approach may be ade-

quate for management purposes, as the turnover of trading portfolios is typically fast—often minutes or hours, rather than days or weeks. That assumption may be too weak, however, for supervisors, who must consider those periods of market turmoil when an instrument's liquidity can disappear. Reducing exposures at those times may require institutions to recognize large losses. The assumption of longer holding periods is particularly important for instruments that have explicit or embedded options because normal daily volatilities may be too low to "trigger" a price shift that can produce a significant change in market value.

The confidence interval is another parameter that would likely require a standardized approach. Currently, when estimating the range of future price movements, each bank decides what confidence level its management needs. Usually, an interval of 95–99 percent is chosen. At that interval, the coverage of possible losses (resulting from a "one-tail" test)[13] translates into roughly 1.7 to 2.3 standard deviations if the observations are distributed "normally," as many bank models assume. The vast majority of daily market movements, however, are small, and their greater frequency overwhelms that of large, highly unusual market shifts when calculating standard deviations. Therefore, when a bank assumes normal distributions, the unusual market events tend to disappear or to have probabilities that seem much more remote than they are in reality. This result is of obvious concern to supervisors—not because of management's practices, but because capital requirements should be based on highly stressful situations, not on "normal" levels of market volatility.

At best, some adjustment of standards seems necessary. The easiest part would be to require relatively strict confidence intervals for all banks, say 99 percent. The more troublesome aspect involves the "fat tails"[14] of the distribution curve: the large, adverse events that normal distributions suggest will almost never happen, but that seem to occur somewhere every few years. One solution would be to use statistical techniques that do not rely on normal distributions; another would be to expand the bank's results by some "adequate," but necessarily arbitrary, multiple. Operationally, this latter approach is probably less disruptive to banking institutions, but it requires determining the "correct" size of the multiplier. Results of true stress tests may help guide that decision.

It is less clear whether other elements need to be standardized. The observation period is an example. In practice, banks seem to use periods ranging from the most recent few months to the past five years or more. Institutions that prefer short time spans believe that the most recent market movements best predict near future volatility; they also want to identify any short-term trends that may exist. Those using long time periods

want to capture a wider range of financial market conditions than is possible with short periods; they place less importance on apparent trends.

In some respects, a bank's selection of observation period can be irrelevant, provided that there is no inherent bias in the model's results. When volatilities are calculated based on standard deviations, short time periods are not necessarily more or less conservative than long periods. Indeed, the use of short periods will at times predict larger potential market movements than long periods because their observations are not "averaged down" by the large numbers of more normal price changes. They will project greater volatility following periods of market instability and less volatility when markets are calm. Although the differences derived from using short and long sample periods may offset in time, different sample periods can produce widely differing estimates of future price movements for similarly risky portfolios at any given time. That result may be unacceptable to supervisors.

With respect to other parameters, permitting banks to use correlations of price changes between different types of products raises questions similar to those just discussed. Some banks calculate correlations among all trading product groups, while others assume, or force, such correlations to be zero, in the belief that any measured linkage—in the price changes of equities versus exchange rates, for example—is coincidental and should not affect the decision-making process. Still other institutions ignore correlations of rate or price movements among broad risk categories altogether and take the most conservative approach of assuming that the correlations are equal to one. Since these diverse practices can significantly affect the level of measured risk, supervisors will need to address this issue themselves as they finalize their capital requirements.

Output of Internal Models

The purpose of an internal model is to estimate the amount of "value at risk," which represents the maximum value that management can expect the portfolio to gain or lose during a specific period (such as one day) with a given level of confidence (for example, 99 percent). Management and supervisors can compare the daily estimate with subsequent results when evaluating the accuracy of the model and the institution's ability to manage risk. While the vast majority of daily results should be within the predicted maximums, one should expect to see results that exceed the estimates more often than the confidence level suggests. As noted above, actual trading gains and losses are not distributed normally, as most models assume; the industry sometimes witnesses extremely good and bad days.

A critical consideration should be the rate at which excesses occur and their distribution among realized gains and losses. If excesses occur much too frequently, one should question the accuracy of the model. If the excesses tend to be mostly losses, one might also question management's ability to respond to adverse market conditions.

Qualitative Factors

A bank may be required to obtain supervisory approval of its internal model before using it for capital purposes, because such a model can involve complex calculations and assumptions and have substantial informational needs. Supervisors should also ensure that the model's results are seen by management (and not generated only for examiners) and that the bank's overall risk-management process is sound.

In July 1994, the Basle Committee on Banking Supervision issued a statement describing sound management practices for derivatives activities.[15] That document could guide bankers with respect to the standards that supervisors could be expected to apply when reviewing their trading activities. First, boards of directors and senior management should exercise appropriate oversight. Directors need not be experts in derivatives or trading practices, but they should approve relevant policies and remain informed of the risks that the institution takes. Senior management would, of course, be expected to provide more extensive oversight and to monitor and control operations closely.

Second, an adequate risk-management process should integrate prudent risk limits, sound measurement procedures and information systems, continuous risk monitoring, and frequent reporting to management. This process should be tailored to the bank's specific activities and staffed with individuals who understand the risks and are independent from the derivatives and trading functions.

Third, there should be comprehensive internal controls and audit procedures. Policies and procedures related to derivatives and trading activities should be fully integrated into routine work flows and consistent with those applied to other operations of the bank.

Conclusion

Developing an international capital standard for trading activities would be a complex and time-consuming process under any conditions. It becomes further complicated, however, when the risk-measurement framework is intended for institutions with significantly different levels of trading activities and expertise. Any agreed-upon approach must be

adaptable to the diverse supervisory regimes in many countries and must involve acceptable costs, both to the supervisors and the regulated institutions. The standard must also, of course, produce a capital requirement that seems reasonable to all concerned.

The option of using internal models to determine capital requirements is attractive to many bankers and bank supervisors alike. Many key questions and issues must first be resolved, but the matter may be coming to fruition, partly as a result of industry comments. The pace and direction of the efforts of the Basle Committee on Banking Supervision are also influenced by other regulatory and political pressures caused by the growth of trading and derivatives activities throughout the world, as well as by highly publicized losses in these markets by both banking and nonbank institutions. Interest in developing and implementing capital standards for market risks is high.

Addendum

In January 1996, the Basle Committee on Banking Supervision issued, subject to completion of appropriate rule-making procedures in member countries, an amendment to its capital standard to address market risk. Most non-European Union (EU) countries are expected to apply the new standards only to their largest institutions, which are relatively heavily involved in trading activities.[16] As mentioned above, EU countries have a Capital Adequacy Directive[17] that applies the standard more broadly to all banking and securities firms operating within their jurisdictions. Affected banking organizations would be required to comply with the Basle Committee requirements by the beginning of 1998, although participating countries may permit institutions to comply voluntarily at an earlier date.

As structured, the final amendment was highly consistent with the approach outlined in this chapter, although the simulation of foreign exchange positions is available only to institutions using the internal modeling approach; otherwise, the more simple technique would be required. The final ruling included these specific requirements regarding the use of internal models: (i) an institution's historical observation period for measuring the volatility of past market movements must be at least one year; (ii) an institution's "value at risk" should be based on a 99 percent confidence level and on an assumed holding period of ten days; and (iii) the modeling of yield curves should consider at least six different points (time bands) on each curve. The results of the modeling process would then be multiplied by three to provide further coverage for extremely adverse market conditions.

That multiplier reflects, in part, an analysis of market volatilities over nearly two decades of market movements and of the amount of capital needed to absorb the largest loss on a hypothetical diversified trading portfolio. The requirement of the ten-day holding period, noted above, is intended only to produce a sufficiently rigorous market movement by, in essence, applying an instantaneous market movement of the size normally experienced over a ten-day period to an institution's existing portfolio. That treatment does not reflect an expectation by supervisors that institutions would actually hold a given trading portfolio for that extended period of time.

The U.S. federal banking agencies approved the amendment in August 1996 but will permit their institutions to use only the internal model approach. This decision reflects their view that internal models provide the best measure of true market risk and their desire to encourage all institutions to improve their processes for managing and measuring this risk.

COMMENT

RAIJA BETTAUER

This comment focuses on some of the issues that have arisen in the United States in the course of implementing the Basle Committee on Banking Supervision's proposals on capital adequacy. One general supervisory and regulatory policy concern that pervades the various issues is the matter of regulatory burden. It is, admittedly, sometimes difficult to find a balance on this issue. On the one hand, if a very simple model is used to measure risk, it may not necessarily yield the most accurate information. The question then arises of why the model was proposed in the first place. On the other hand, if a complex and detailed model is required, it may not be suited to institutions that, for example, have small, specialized operations. In fact, such a model may well be burdensome for those institutions, as it could lead to an increase in their operational costs. Supervisors are sensitive to this balancing process. In the United States, the regulation of banking is extensive, and supervisors are accordingly aware of the burden that it imposes on banks. Approximately 14 percent of the banks' expenses are devoted to complying with regulatory requirements.

Netting

The 1994 proposal[1] by the Basle Committee to take account of netting arrangements in the calculation of capital adequacy has been implemented in the United States. When the proposed rules[2] were being drafted, there were a couple of issues of particular significance. First, to qualify for netting, there must be an enforceable contract that can survive a counterparty's default, bankruptcy, or insolvency. When the parties are under different jurisdictions—which can be either different state jurisdictions in the United States or very different legal frameworks across countries—it can become difficult to ascertain the effect of bankruptcy proceedings on the enforceability of contracts. Therefore, the requirement that the banks must provide legal opinions on the enforceability of the contracts to which they are parties may, in some cases, be difficult to fulfill. However, there does not seem to be any alternative: if there is no sufficient legal certitude in these matters, netting cannot be a valid option for capital adequacy purposes. The problem is further complicated in the case of bankruptcy, which may involve as counterparties not only financial institutions but also ordinary nonfinancial corporations. Bankruptcy

and insolvency rules applicable to ordinary corporations may differ from those applicable to financial institutions.

With respect to the issue of regulatory burden, bank supervisors are aware that forcing a bank to go to an outside law firm every time that a legal opinion concerning the enforceability of a contract is required can become costly and may, in fact, be unnecessary. Another option is for the bank to have its own in-house legal counsel produce the opinion.

The Basle Committee did not expect that there would be an international harmonization of legal rules or opinions, or that similar opinions would be required of every member. Instead, banking supervisors in all member countries have been given the discretion to evaluate the sufficiency of their countries' legal opinions. Because of the different legal frameworks, this seems like the sensible thing to do. Nevertheless, this requirement will obligate legal counsels and supervisory agencies to determine the sufficiency of these opinions.

Also noteworthy in the netting proposal was the suggestion—similar to that in the Basle Committee's consultative papers—that, for risk-based capital purposes, contracts involving walkaway clauses be ineligible for netting.[3] Moreover, in a bankruptcy case, the bankruptcy court or receiver must not be given option to "cherry-pick" the contract. If the rule were otherwise, the administrator of the bankrupt estate could pick and choose among the contracts, upholding those contracts in which the bankrupt estate was on the receiving side and disavowing those calling for payments by the estate. In some countries it may even be the duty of the administrator to cherry-pick, based on its fiduciary responsibilities. This is a matter that the legal counsel needs to look at when reviewing netting contracts.

Derivatives

The Basle Committee is looking at another increasingly prominent issue: supervision of the financial institutions using derivatives. The Eurocurrency Standing Committee of the Bank for International Settlements is also looking into these matters, as is the International Organization of Securities Commissions. It is possible that these agencies and organizations may eventually coordinate their recommendations, at least on some points.

A banking circular issued by the Office of the Comptroller of the Currency (OCC) highlighted for banks the standards that banks should maintain in their derivatives management practices.[4] The OCC has also issued additional guidance in the form of questions and answers about

derivatives use.[5] In addition, the Basle Committee prepared guidelines on risk management of derivatives.[6]

The Basle Committee is committed to cooperating with other banking supervisory groups around the world. All concerned are aware of the need to harmonize and cooperate where possible, because banking has become increasingly international. The Basle Committee engages at least once a year in consultations with other supervisory groups. Similarly, the Basle Committee is considering holding annual or more frequent consultations with securities and insurance supervisors because of the issues that are increasingly overlapping their respective jurisdictions. Finally, the International Conference of Banking Supervisors, which has a larger membership than the Basle Committee, holds a conference every two years in which these and similar matters are considered.

Appendix I
International Agreements

Appendix I

1 General Agreement on Trade in Services

Members,*

Recognizing the growing importance of trade in services for the growth and development of the world economy;

Wishing to establish a multilateral framework of principles and rules for trade in services with a view to the expansion of such trade under conditions of transparency and progressive liberalization and as a means of promoting the economic growth of all trading partners and the development of developing countries;

Desiring the early achievement of progressively higher levels of liberalization of trade in services through successive rounds of multilateral negotiations aimed at promoting the interests of all participants on a mutually advantageous basis and at securing an overall balance of rights and obligations, while giving due respect to national policy objectives;

Recognizing the right of Members to regulate, and to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives and, given asymmetries existing with respect to the degree of development of services regulations in different countries, the particular need of developing countries to exercise this right;

Desiring to facilitate the increasing participation of developing countries in trade in services and the expansion of their service exports including, *inter alia*, through the strengthening of their domestic services capacity and its efficiency and competitiveness;

Taking particular account of the serious difficulty of the least-developed countries in view of their special economic situation and their development, trade and financial needs;

Hereby *agree* as follows:

---

*This text is reproduced with permission of the GATT Secretariat. The GATS is part of the Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, December 15, 1993, *reprinted in The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts* 327 (1994).

PART I
SCOPE AND DEFINITION

Article I
Scope and Definition

1. This Agreement applies to measures by Members affecting trade in services.

2. For the purposes of this Agreement, trade in services is defined as the supply of a service;

(a) from the territory of one Member into the territory of any other Member;

(b) in the territory of one Member to the service consumer of any other Member;

(c) by a service supplier of one Member, through commercial presence in the territory of any other Member;

(d) by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member.

3. For the purposes of this Agreement:

(a) "measures by Members" means measures taken by:

(i) central, regional or local governments and authorities; and

(ii) non-governmental bodies in the exercise of powers delegated by central, regional or local governments or authorities.

In fulfilling its obligations and commitments under the Agreement, each Member shall take such reasonable measures as may be available to it to ensure their observance by regional and local governments and authorities and non-governmental bodies within its territory;

(b) "services" includes any service in any sector except services supplied in the exercise of governmental authority;

(c) "a service supplied in the exercise of governmental authority" means any service which is supplied neither on a commercial basis nor in competition with one or more service suppliers.

PART II
GENERAL OBLIGATIONS AND DISCIPLINES

Article II
Most-Favoured-Nation Treatment

1. With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and

service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.

2. A Member may maintain a measure inconsistent with paragraph 1 provided that such a measure is listed in, and meets the conditions of, the Annex on Article II Exemptions.

3. The provisions of this Agreement shall not be so construed as to prevent any Member from conferring or according advantages to adjacent countries in order to facilitate exchanges limited to contiguous frontier zones of services that are both locally produced and consumed.

Article III
Transparency

1. Each Member shall publish promptly and, except in emergency situations, at the latest by the time of their entry into force, all relevant measures of general application which pertain to or affect the operation of this Agreement. International agreements pertaining to or affecting trade in services to which a Member is a signatory shall also be published.

2. Where publication as referred to in paragraph 1 is not practicable, such information shall be made otherwise publicly available.

3. Each Member shall promptly and at least annually inform the Council for Trade in Services of the introduction of any new, or any changes to existing, laws, regulations or administrative guidelines which significantly affect trade in services covered by its specific commitments under this Agreement.

4. Each Member shall respond promptly to all requests by any other Member for specific information on any of its measures of general application or international agreements within the meaning of paragraph 1. Each Member shall also establish one or more enquiry points to provide specific information to other Members, upon request, on all such matters as well as those subject to the notification requirement in paragraph 3. Such enquiry points shall be established within two years from the date of entry into force of the Agreement Establishing the WTO (referred to in this Agreement as the "WTO Agreement"). Appropriate flexibility with respect to the time-limit within which such enquiry points are to be established may be agreed upon for individual developing country Members. Enquiry points need not be depositories of laws and regulations.

5. Any Member may notify to the Council for Trade in Services any measure, taken by any other Member, which it considers affects the operation of this Agreement.

Article III bis
Disclosure of Confidential Information

Nothing in this Agreement shall require any Member to provide confidential information, the disclosure of which would impede law enforcement, or otherwise be contrary to the public interest, or which would prejudice legitimate commercial interests of particular enterprises, public or private.

Article IV
Increasing Participation of Developing Countries

1. The increasing participation of developing country Members in world trade shall be facilitated through negotiated specific commitments, by different Members pursuant to Parts III and IV of this Agreement, relating to:

(a) the strengthening of their domestic services capacity and its efficiency and competitiveness, *inter alia* through access to technology on a commercial basis;

(b) the improvement of their access to distribution channels and information networks; and

(c) the liberalization of market access in sectors and modes of supply of export interest to them.

2. Developed country Members, and to the extent possible other Members, shall establish contact points within two years from the date of entry into force of the WTO Agreement to facilitate the access of developing country Members' service suppliers to information, related to their respective markets, concerning:

(a) commercial and technical aspects of the supply of services;

(b) registration, recognition and obtaining of professional qualifications; and

(c) the availability of services technology.

3. Special priority shall be given to the least-developed country Members in the implementation of paragraphs 1 and 2. Particular account shall be taken of the serious difficulty of the least-developed countries in accepting negotiated specific commitments in view of their special economic situation and their development, trade and financial needs.

Article V
Economic Integration

1. This Agreement shall not prevent any of its Members from being a party to or entering into an agreement liberalizing trade in services

between or among the parties to such an agreement, provided that such an agreement:

(a) has substantial sectoral coverage,[1] and

(b) provides for the absence of elimination of substantially all discrimination, in the sense of Article XVII, between or among the parties, in the sectors covered under subparagraph (a), through;

(i) elimination of existing discriminatory measures, and/or

(ii) prohibition of new or more discriminatory measures,

at the entry into force of that agreement or on the basis of a reasonable time-frame, except for measures permitted under Articles XI, XII, XIV, and XIV bis.

2. In evaluating whether the conditions under paragraph 1(b) are met, consideration may be given to the relationship of the agreement to a wider process of economic integration or trade liberalization among the countries concerned.

3. (a) Where developing countries are parties to an agreement of the type referred to in paragraph 1, flexibility shall be provided for regarding the conditions set out in paragraph 1, particularly with reference to subparagraph (b) thereof, in accordance with the level of development of the countries concerned, both overall and in individual sectors and subsectors.

(b) Notwithstanding paragraph 6, in the case of an agreement of the type referred to in paragraph 1 involving only developing countries, more favourable treatment may be granted to juridical persons owned or controlled by natural persons of the parties to such an agreement.

4. Any agreement referred to in paragraph 1 shall be designed to facilitate trade between the parties to the agreement and shall not in respect of any Member outside the agreement raise the overall level of barriers to trade in services within the respective sectors or subsectors compared to the level applicable prior to such an agreement.

5. If, in the conclusion, enlargement or any significant modification of any agreement under paragraph 1, a Member intends to withdraw or modify a specific commitment inconsistently with the terms and conditions set out in its Schedule, it shall provide at least 90 days advance

[1]This condition is understood in terms of number of sectors, volume of trade affected and modes of supply. In order to meet this condition, agreements should not provide for the *a priori* exclusion of any mode of supply.

notice of such modification or withdrawal and the procedure set forth in paragraphs 2, 3 and 4 of Article XXI shall apply.

6. A service supplier of any other Member that is a juridical person constituted under the laws of a party to an agreement referred to in paragraph 1 shall be entitled to treatment granted under such agreement, provided that it engages in substantive business operations in the territory of the parties to such agreement.

7. (a) Members which are parties to any agreement referred to in paragraph 1 shall promptly notify any such agreement and any enlargement or any significant modification of that agreement to the Council for Trade in Services. They shall also make available to the Council such relevant information as may be requested by it. The Council may establish a working party to examine such an agreement or enlargement or modification of that agreement and to report to the Council on its consistency with this Article.

(b) Members which are parties to any agreement referred to in paragraph 1 which is implemented on the basis of a time-frame shall report periodically to the Council for Trade in Services on its implementation. The Council may establish a working party to examine such reports if it deems such a working party necessary.

(c) Based on the reports of the working parties referred to in subparagraphs (a) and (b), the Council may make recommendations to the parties as it deems appropriate.

8. A Member which is a party to any agreement referred to in paragraph 1 may not seek compensation for trade benefits that may accrue to any other Member from such agreement.

Article V bis
Labour Markets Integration Agreements

This Agreement shall not prevent any of its Members from being a party to an agreement establishing full integration[2] of the labour markets between or among the parties to such an agreement, provided that such an agreement:

(a) exempts citizens of parties to the agreement from requirements concerning residency and work permits;

(b) is notified to the Council for Trade in Services.

[2] Typically, such integration provides citizens of the parties concerned with a right of free entry to the employment markets of the parties and includes measures concerning conditions of pay, other conditions of employment and social benefits.

Article VI
Domestic Regulation

1. In sectors where specific commitments are undertaken, each Member shall ensure that all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner.

2. (a) Each member shall maintain or institute as soon as practicable juridical, arbitral or administrative tribunals or procedures which provide, at the request of an affected service supplier, for the prompt review of, and where justified, appropriate remedies for, administrative decisions affecting trade in services. Where such procedures are not independent of the agency entrusted with the administrative decision concerned, the Member shall ensure that the procedures in fact provide for an objective and impartial review.

(b) The provisions of subparagraph (a) shall not be construed to require a Member to institute such tribunals or procedures where this would be inconsistent with its constitutional structure or the nature of its legal system.

3. Where authorization is required for the supply of a service on which a specific commitment has been made, the competent authorities of a Member shall, within a reasonable period of time after the submission of an application considered complete under domestic laws and regulations, inform the applicant of the decision concerning the application. At the request of the applicant, the competent authorities of the Member shall provide, without undue delay, information concerning the status of the application.

4. With a view to ensuring that measures relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services, the Council for Trade in Services shall, through appropriate bodies it may establish, develop any necessary disciplines. Such disciplines shall aim to ensure that such requirements are, ***inter alia***:

(a) based on objective and transparent criteria, such as competence and the ability to supply the service;

(b) not more burdensome than necessary to ensure the quality of the service;

(c) in the case of licensing procedures, not in themselves a restriction on the supply of the service.

5. (a) In sectors in which a Member has undertaken specific commitments, pending the entry into force of disciplines developed in these sectors pursuant to paragraph 4, the Member shall not apply licensing and qualification requirements and technical standards that nullify or impair such specific commitments in a manner which:

(i) does not comply with the criteria outlined in subparagraphs 4(a), (b) or (c); and

(ii) could not reasonably have been expected of that Member at the time the specific commitments in those sectors were made.

(b) In determining whether a Member is in conformity with the obligation under paragraph 5(a), account shall be taken of international standards of relevant international organizations[3] applied by that Member.

6. In sectors where specific commitments regarding professional services are undertaken, each Member shall provide for adequate procedures to verify the competence of professionals of any other Member.

Article VII
Recognition

1. For the purpose of fulfilment, in whole or in part, of its standards or criteria for the authorization, licensing or certification of services suppliers, and subject to the requirements of paragraph 3, a Member may recognize the education or experience obtained, requirements met, or licenses or certifications granted in a particular country. Such recognition, which may be achieved through harmonization or otherwise, may be based upon an agreement or arrangement with the country concerned or may be accorded autonomously.

2. A Member that is a party to an agreement or arrangement of the type referred to in paragraph 1, whether existing or future, shall afford adequate opportunity for other interested Members to negotiate their accession to such an agreement or arrangement or to negotiate comparable ones with it. Where a Member accords recognition autonomously, it shall afford adequate opportunity for any other Member to demonstrate that education, experience, licenses, or certifications obtained or requirements met in that other Member's territory should be recognized.

3. A Member shall not accord recognition in a manner which would constitute a means of discrimination between countries in the application

[3]The term "relevant international organizations" refers to international bodies whose membership is open to the relevant bodies of at least all Members of the WTO.

of its standards or criteria for the authorization, licensing or certification of services suppliers, or a disguised restriction on trade in services.

4. Each Member shall:

(a) within 12 months from the date on which the WTO Agreement takes effect for it, inform the Council for Trade in Services of its existing recognition measures and state whether such measures are based on agreements or arrangements of the type referred to in paragraph 1;

(b) promptly inform the Council for Trade in Services as far in advance as possible of the opening of negotiations on an agreement or arrangement of the type referred to in paragraph 1 in order to provide adequate opportunity to any other Member to indicate their interest in participating in the negotiations before they enter a substantive phase;

(c) promptly inform the Council for Trade in Services when it adopts new recognition measures or significantly modifies existing ones and state whether the measures are based on an agreement or arrangement of the type referred to in paragraph 1.

5. Wherever appropriate, recognition should be based on multilaterally agreed criteria. In appropriate cases, Members shall work in cooperation with relevant intergovernmental and non-governmental organizations towards the establishment and adoption of common international standards and criteria for recognition and common international standards for the practice of relevant services trades and professions.

Article VIII
Monopolies and Exclusive Service Suppliers

1. Each Member shall ensure that any monopoly supplier of a service in its territory does not, in the supply of the monopoly service in the relevant market, act in a manner inconsistent with that Member's obligations under Article II and specific commitments.

2. Where a Member's monopoly supplier competes, either directly or through an affiliated company, in the supply of a service outside the scope of its monopoly rights and which is subject to that Member's specific commitments, the Member shall ensure that such a supplier does not abuse its monopoly position to act in its territory in a manner inconsistent with such commitments.

3. The Council for Trade in Services may, at the request of a Member which has a reason to believe that a monopoly supplier of a service of any other Member is acting in a manner inconsistent with paragraph 1 or 2,

request the Member establishing, maintaining or authorizing such supplier to provide specific information concerning the relevant operations.

4. If, after the date of entry into force of the WTO Agreement, a Member grants monopoly rights regarding the supply of a service covered by its specific commitments, that Member shall notify the Council for Trade in Services no later than three months before the intended implementation of the grant of monopoly rights and the provisions of paragraphs 2, 3 and 4 of Article XXI shall apply.

5. The provisions of this Article shall also apply to cases of exclusive service suppliers, where a Member, formally or in effect, (a) authorizes or establishes a small number of service suppliers and (b) substantially prevents competition among those suppliers in its territory.

Article IX
Business Practices

1. Members recognize that certain business practices of service suppliers, other than those falling under Article VIII, may restrain competition and thereby restrict trade in services.

2. Each Member shall, at the request of any other Member, enter into consultations with a view to eliminating practices referred to in paragraph 1. The Member addressed shall accord full and sympathetic consideration to such a request and shall cooperate through the supply of publicly available non-confidential information of relevance to the matter in question. The Member addressed shall also provide other information available to the requesting Member, subject to its domestic law and to the conclusion of satisfactory agreement concerning the safeguarding of its confidentiality by the requesting Member.

Article X
Emergency Safeguard Measures

1. There shall be multilateral negotiations on the question of emergency safeguard measures based on the principle of non-discrimination. The results of such negotiations shall enter into effect on a date not later than three years from the date of entry into force of the WTO Agreement.

2. In the period before the entry into effect of the results of the negotiations referred to in paragraph 1, any Member may, notwithstanding the provisions of paragraph 1 of Article XXI, notify the Council on Trade in Services of its intention to modify or withdraw a specific commitment after a period of one year from the date on which the commitment enters into force; provided that the Member shows cause to the Council that the

modification or withdrawal cannot await the lapse of the three-year period provided for in paragraph 1 of Article XXI.

3. The provisions of paragraph 2 shall cease to apply three years after the date of entry into force of the WTO Agreement.

Article XI
Payments and Transfers

1. Except under the circumstances envisaged in Article XII, a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments.

2. Nothing in this Agreement shall affect the rights and obligations of the members of the International Monetary Fund under the Articles of Agreement of the Fund, including the use of exchange actions which are in conformity with the Articles of Agreement, provided that a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions, except under Article XII or at the request of the Fund.

Article XII
Restrictions to Safeguard the Balance of Payments

1. In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. It is recognized that particular pressures on the balance of payments of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, ***inter alia***, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition.

2. The restrictions referred to in paragraph 1:

(a) shall not discriminate among Members;

(b) shall be consistent with the Articles of Agreement of the International Monetary Fund;

(c) shall avoid unnecessary damage to the commercial, economic and financial interests of any other Member;

(d) shall not exceed those necessary to deal with the circumstances described in paragraph 1;

(e) shall be temporary and be phased out progressively as the situation specified in paragraph 1 improves.

3. In determining the incidence of such restrictions, Members may give priority to the supply of services which are more essential to their economic or development programmes. However, such restrictions shall not be adopted or maintained for the purpose of protecting a particular service sector.

4. Any restrictions adopted or maintained under paragraph 1, or any changes therein, shall be promptly notified to the General Council.

5. (a) Members applying the provisions of this Article shall consult promptly with the Committee on Balance-of-Payments Restrictions on restrictions adopted under this Article.

(b) The Ministerial Conference shall establish procedures[4] for periodic consultations with the objective of enabling such recommendations to be made to the Member concerned as it may deem appropriate.

(c) Such consultations shall assess the balance-of-payment situation of the Member concerned and the restrictions adopted or maintained under this Article, taking into account, *inter alia*, such factors as:

(i) the nature and extent of the balance-of-payments and the external financial difficulties;

(ii) the external economic and trading environment of the consulting Member;

(iii) alternative corrective measures which may be available.

(d) The consultations shall address the compliance of any restrictions with paragraph 2, in particular the progressive phaseout of restrictions in accordance with paragraph 2(e).

(e) In such consultations, all findings of statistical and other facts presented by the International Monetary Fund relating to foreign exchange, monetary reserves and balance of payments, shall be accepted and conclusions shall be based on the assessment by the Fund of the balance-of-payments and the external financial situation of the consulting Member.

6. If a Member which is not a member of the International Monetary Fund wishes to apply the provisions of this Article, the Ministerial

[4]It is understood that the procedures under paragraph 5 shall be the same as the GATT 1994 procedures.

Conference shall establish a review procedure and any other procedures necessary.

Article XIII
Government Procurement

1. Articles II, XVI and XVII shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of services purchased for governmental purposes and not with a view to commercial resale or with a view to use in the supply of services for commercial sale.

2. There shall be multilateral negotiations on government procurement in services under this Agreement within two years from the date of entry into force of the WTO Agreement.

Article XIV
General Exceptions

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures:

(a) necessary to protect public morals or to maintain public order;[5]

(b) necessary to protect human, animal or plant life or health;

(c) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement including those relating to:

(i) the prevention of deceptive and fraudulent practices or to deal with the effects of a default on services contracts;

(ii) the protection of the privacy of individuals in relation to the processing and dissemination of personal data and the protection of confidentiality of individual records and accounts;

(iii) safety;

[5]The public order exception may be invoked only where a genuine and sufficiently serious threat is posed to one of the fundamental interests of society.

(d) inconsistent with Article XVII, provided that the difference in treatment is aimed at ensuring the equitable or effective[6] imposition or collection of direct taxes in respect of services or service suppliers of other Members;

(e) inconsistent with Article II, provided that the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Member is bound.

Article XIV bis
Security Exceptions

1. Nothing in this Agreement shall be construed:

(a) to require any Member to furnish any information, the disclosure of which it considers contrary to its essential security interests; or

(b) to prevent any Member from taking any action which it considers necessary for the protection of its essential security interests:

(i) relating to the supply of services as carried out directly or indirectly for the purpose of provisioning a military establishment;

(ii) relating to fissionable and fusionable materials or the materials from which they are derived;

(iii) taken in time of war or other emergency in international relations; or

---

[6]Measures that are aimed at ensuring the equitable or effective imposition or collection of direct taxes include measures taken by a Member under its taxation system which:

(i) apply to non-resident service suppliers in recognition of the fact that the tax obligation of non-residents is determined with respect to taxable items sourced or located in the Members' territory; or

(ii) apply to non-residents in order to ensure the imposition or collection of taxes in the Member's territory; or

(iii) apply to non-residents or residents in order to prevent the avoidance or evasion of taxes, including compliance measures; or

(iv) apply to consumers of services supplied in or from the territory of another Member in order to ensure the imposition or collection of taxes on such consumers derived from sources in the Member's territory; or

(v) distinguish service suppliers subject to tax on worldwide taxable items from other service suppliers, in recognition of the difference in the nature of the tax base between them; or

(vi) determine, allocate or apportion income, profit, gain, loss, deduction or credit of resident persons or branches, or between related persons or branches of the same person, in order to safeguard the Member's tax base.

Tax terms or concepts in paragraph (d) of Article XIV and in this footnote are determined according to tax definitions and concepts, or equivalent or similar definitions and concepts, under the domestic law of the Member taking the measure.

(c) to prevent any Member from taking any action in pursuance of its obligations under the United Nations Charter for the maintenance of international peace and security;

2. The Council for Trade in Services shall be informed to the fullest extent possible of measures taken under paragraphs 1(b) and (c) and of their termination.

Article XV
Subsidies

1. Members recognize that, in certain circumstances, subsidies may have distortive effects on trade in services. Members shall enter into negotiations with a view to developing the necessary multilateral disciplines to avoid such trade-distortive effects.[7] The negotiations shall also address the appropriateness of countervailing procedures. Such negotiations shall recognize the role of subsidies in relation to the development programmes of developing countries and take into account the needs of Members, particularly developing country Members, for flexibility in this area. For the purpose of such negotiations, Members shall exchange information concerning all subsidies related to trade in services that they provide to their domestic service suppliers.

2. Any Member which considers that it is adversely affected by a subsidy of another Member may request consultations with that Member on such matters. Such requests shall be accorded sympathetic consideration.

PART III
SPECIFIC COMMITMENTS

Article XVI
Market Access

1. With respect to market access through the modes of supply identified in Article 1, each Member shall accord services and service suppliers of any other Member treatment no less favourable than that provided for under the terms, limitations and conditions agreed and specified in its schedule.[8]

---

[7]A future work programme shall determine how, and in what time-frame negotiations on such multilateral disciplines will be conducted.

[8]If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article 1 and if the cross-border movement of capital is an essential part of the service itself, that Member is thereby committed to allow such movement of capital. If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(c) of Article 1, it is thereby committed to allow related transfers of capital into its territory.

2. In sectors where market-access commitments are undertaken, the measures which a Member shall not maintain or adopt either on the basis of a regional subdivision or on the basis of its entire territory, unless otherwise specified in its Schedule, are defined as:

(a) limitations on the number of service suppliers whether in the form of numerical quotas, monopolies, exclusive service suppliers or the requirements of an economic needs test;

(b) limitations on the total value of service transactions or assets in the form of numerical quotas or the requirement of an economic needs test;

(c) limitations on the total number of service operations or on the total quantity of service output expressed in terms of designated numerical units in the form of quotas or the requirement of an economic needs test;[9]

(d) limitations on the total number of natural persons that may be employed in a particular service sector or that a service supplier may employ and who are necessary for, and directly related to, the supply of a specific service in the form of numerical quotas or the requirement of an economic needs test;

(e) measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; and

(f) limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment.

Article XVII
National Treatment

1. In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.[10]

[9]Subparagraph 2(c) does not cover measures of a Member which limit inputs for the supply of services.

[10]Specific commitments assumed under this Article shall not be construed to require any Member to compensate for any inherent competitive disadvantages which result from the foreign character of the relevant services or service suppliers.

2. A Member may meet the requirement of paragraph 1 by according to services and service suppliers of any other Member, either formally identical treatment or formally different treatment to that it accords to its own like services and service suppliers.

3. Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member.

Article XVIII
Additional Commitments

Members may negotiate commitments with respect to measures affecting trade in services not subject to scheduling under Articles XVI or XVII, including those regarding qualifications, standards or licensing matters. Such commitments shall be inscribed in a Member's Schedule.

PART IV
PROGRESSIVE LIBERALIZATION

Article XIX
Negotiation of Specific Commitments

1. In pursuance of the objectives of this Agreement, Members shall enter into successive rounds of negotiations, beginning not later than five years from the date of entry into force of the WTO Agreement and periodically thereafter, with a view to achieving a progressively higher level of liberalization. Such negotiations shall be directed to the reduction or elimination of the adverse effects on trade in services of measures as a means of providing effective market access. This process shall take place with a view to promoting the interests of all participants on a mutually advantageous basis and to securing an overall balance of rights and obligations.

2. The process of liberalization shall take place with due respect for national policy objectives and the level of development of individual Members, both overall and in individual sectors. There shall be appropriate flexibility for individual developing country Members for opening fewer sectors, liberalizing fewer types of transactions, progressively extending market access in line with their development situation and, when making access to their markets available to foreign service suppliers, attaching to such access conditions aimed at achieving the objectives referred to in Article IV.

3. For each round, negotiating guidelines and procedures shall be established. For the purposes of establishing such guidelines, the Council for Trade in Services shall carry out an assessment of trade in services in overall terms and on a sectoral basis with reference to the objectives of the Agreement, including those set out in paragraph 1 of Article IV. Negotiating guidelines shall establish modalities for the treatment of liberalization undertaken autonomously by Members since previous negotiations, as well as for the special treatment for least-developed country Members under the provisions of paragraph 3 of Article IV.

4. The process of progressive liberalization shall be advanced in each such round through bilateral, plurilateral or multilateral negotiations directed towards increasing the general level of specific commitments undertaken by Members under this Agreement.

Article XX
Schedules of Specific Commitments

1. Each Member shall set out in a schedule the specific commitments it undertakes under Part III of this Agreement. With respect to sectors where such commitments are undertaken, each Schedule shall specify:

(a) terms, limitations and conditions on market access;

(b) conditions and qualifications on national treatment;

(c) undertakings related to additional commitments;

(d) where appropriate the time-frame for implementation of such commitments; and

(e) the date of entry into force of such commitments.

2. Measures inconsistent with both Articles XVI and XVII shall be inscribed in the column relating to Article XVI. In this case the inscription will be considered to provide a condition or qualification to Article XVII as well.

3. Schedules of specific commitments shall be annexed to this Agreement and shall form an integral part thereof.

Article XXI
Modification of Schedules

1. (a) A Member (referred to in this Article as the "modifying Member") may modify or withdraw any commitment in its Schedule, at any time after three years have elapsed from the date on which that com-

mitment entered into force, in accordance with the provisions of this Article.

(b) A modifying Member shall notify its intent to modify or withdraw a commitment pursuant to this Article to the Council for Trade in Services no later than three months before the intended date of implementation of the modification or withdrawal.

2. (a) At the request of any Member the benefits of which under this Agreement may be affected (referred to in this Article as an "affected Member") by a proposed modification or withdrawal notified under subparagraph 1(b), the modifying Member shall enter into negotiations with a view to reaching agreement on any necessary compensatory adjustment. In such negotiations and agreement, the Members concerned shall endeavour to maintain a general level of mutually advantageous commitments not less favourable to trade than that provided for in Schedules of specific commitments prior to such negotiations.

(b) Compensatory adjustments shall be made on a most-favoured-nation basis.

3. (a) If agreement is not reached between the modifying Member and any affected Member before the end of the period provided for negotiations, such affected Member may refer the matter to arbitration. Any affected Member that wishes to enforce a right that it may have to compensation must participate in the arbitration.

(b) If no affected Member has requested arbitration, the modifying Member shall be free to implement the proposed modification or withdrawal.

4. (a) The modifying Member may not modify or withdraw its commitment until it has made compensatory adjustments in conformity with the findings of the arbitration.

(b) If the modifying Member implements its proposed modification or withdrawal and does not comply with the findings of the arbitration, any affected Member that participated in the arbitration may modify or withdraw substantially equivalent benefits in conformity with those findings. Notwithstanding Article II, such a modification or withdrawal may be implemented solely with respect to the modifying Member.

5. The Council for Trade in Services shall establish procedures for rectification or modification of Schedules. Any Member which has modified or withdrawn scheduled commitments under this Article shall modify its Schedule according to such procedures.

PART V
INSTITUTIONAL PROVISIONS

Article XXII
Consultation

1. Each Member shall accord sympathetic consideration to, and shall afford adequate opportunity for, consultation regarding such representations as may be made by any other Member with respect to any matter affecting the operation of this Agreement. The Dispute Settlement Understanding (DSU) shall apply to such consultations.

2. The Council for Trade in Services or the Dispute Settlement Body (DSB) may, at the request of a Member, consult with any Member or Members in respect of any matter for which it has not been possible to find a satisfactory solution through consultation under paragraph 1.

3. A Member may not invoke Article XVII, either under this Article or Article XXIII, with respect to a measure of another Member that falls within the scope of an international agreement between them relating to the avoidance of double taxation. In case of disagreement between Members as to whether a measure falls within the scope of such an agreement between them, it shall be open to either Member to bring this matter before the Council for Trade in Services.[11] The Council shall refer the matter to arbitration. The decision of the arbitrator shall be final and binding on the Members.

Article XXIII
Dispute Settlement and Enforcement

1. If any Member should consider that any other Member fails to carry out its obligations or specific commitments under this Agreement, it may with a view to reaching a mutually satisfactory resolution of the matter, have recourse to the DSU.

2. If the DSB considers that the circumstances are serious enough to justify such action, it may authorize a Member or Members to suspend the application to any other Member or Members of such obligations and specific commitments in accordance with Article 22 of the DSU.

3. If any Member considers that any benefit it could reasonably have expected to accrue to it under a specific commitment of another Member under Part III of this Agreement is being nullified or impaired as a result of

[11]With respect to agreements on the avoidance of double taxation which exist on the date of entry into force of the WTO Agreement, such a matter may be brought before the Council for Trade in Services only with the consent of both parties to such an agreement.

the application of any measure which does not conflict with the provisions of this Agreement, it may have recourse to the DSU. If the measure is determined by the DSB to have nullified or impaired such a benefit, the Member affected shall be entitled to a mutually satisfactory adjustment on the basis of paragraph 2 of Article XXI, which may include the modification or withdrawal of the measure. In the event an agreement cannot be reached between the Members concerned, Article 22 of the DSU shall apply.

Article XXIV
Council for Trade in Services

1. The Council for Trade in Services shall carry out such functions as may be assigned to it to facilitate the operation of this Agreement and further its objectives. The Council may establish such subsidiary bodies as it considers appropriate for the effective discharge of its functions.

2. The Council and, unless the Council decides otherwise, its subsidiary bodies shall be open to participation by representatives of all Members.

3. The Chairman of the Council shall be elected by the Members.

Article XXV
Technical Cooperation

1. Service suppliers of Members which are in need of such assistance shall have access to the services of contact points referred to in paragraph 2 of Article IV.

2. Technical assistance to developing countries shall be provided at the multilateral level by the Secretariat and shall be decided upon by the Council for Trade in Services.

Article XXVI
Relationship with Other International Organizations

The General Council shall make appropriate arrangements for consultation and cooperation with the United Nations and its specialized agencies as well as with other intergovernmental organizations concerned with services.

PART VI
FINAL PROVISIONS

Article XXVII
Denial of Benefits

A Member may deny the benefits of this Agreement:

(a) to the supply of a service, if it establishes that the service is supplied from or in the territory of a non-Member, or of a Member to which the denying Member does not apply the WTO Agreement;

(b) in the case of the supply of a maritime transport service, if it establishes that the service is supplied:

(i) by a vessel registered under the laws of a non-Member or of a Member to which the denying Member does not apply the WTO Agreement, and

(ii) by a person which operates and/or uses the vessel in whole or in part but which is of a non-Member or of a Member to which the denying Member does not apply the WTO Agreement;

(c) to a service supplier that is a juridical person, if it establishes that it is not a service supplier of another Member, or that it is a service supplier of a Member to which the denying Member does not apply the WTO Agreement.

Article XXVIII
Definitions

For the purpose of this Agreement:

(a) "measure" means any measure by a Member, whether in the form of a law, regulation, rule, procedure, decision, administrative action, or any other form;

(b) "supply of service" includes the production, distribution, marketing, sale and delivery of a service;

(c) "measures by Members affecting trade in services" include measures in respect of

(i) the purchase, payment or use of a service;

(ii) the access to and use of, in connection with the supply of a service, services which are required by those Members to be offered to the public generally;

(iii) the presence, including commercial presence, of persons of a Member for the supply of a service in the territory of another Member;

(d) "commercial presence" means any type of business or professional establishment, including through

(i) the constitution, acquisition or maintenance of a juridical person, or

(ii) the creation or maintenance of a branch or a representative office, within the territory of a Member for the purpose of supplying a service;

(e) "sector" of a service means,

(i) with reference to a specific commitment, one or more, or all, subsectors of that service, as specified in the Member's Schedule,

(ii) otherwise, the whole of that service sector, including all of its subsectors;

(f) "service of another Member" means a service which is supplied,

(i) from or in the territory of that other Member, or in the case of maritime transport, by a vessel registered under the laws of that other Member, or by a person of that other Member which supplies the service through the operation of a vessel and/or its use in whole or in part; or

(ii) in the case of the supply of a service through commercial presence or through the presence of natural persons, by a service supplier of that other Member;

(g) "service supplier" means any person that supplies a service;[12]

(h) "monopoly supplier of a service" means any person, public or private, which in the relevant market of the territory of a Member is authorized or established formally or in effect by that Member as the sole supplier of that service;

(i) "service consumer" means any person that receives or uses a service;

(j) "person" means either a natural person or a juridical person;

(k) "natural person of another Member" means a natural person who resides in the territory of that other Member or any other Member, and who under the law of that other Member:

(i) is a national of that other Member; or

(ii) has the right of permanent residence in that other Member, in the case of a Member which:

[12]Where the service is not supplied directly by a juridical person but through other forms of commercial presence such as a branch or a representative office, the service supplier, (i.e. the juridical person) shall, nonetheless, though such presence be accorded the treatment provided for service suppliers under the Agreement. Such treatment shall be extended to the presence through which the service is supplied and need not be extended to any other parts of the supplier located outside the territory where the service is supplied.

1. does not have nationals; or

2. accords substantially the same treatment to its permanent residents as it does to its nationals in respect of measures affecting trade services, as notified in its acceptance of or accession to the WTO Agreement, provided that no Member is obligated to accord to such permanent residents treatment more favourable than would be accorded by that other Member to such permanent residents. Such notification shall include the assurance to assume, with respect to those permanent residents, in accordance with its laws and regulations, the same responsibilities that other Member bears with respect to its nationals;

(l) "juridical person" means any legal entity duly constituted or otherwise organized under applicable law, whether for profit or otherwise, and whether privately-owned or governmentally owned, including any corporation, trust, partnership, joint venture, sole proprietorship or association;

(m) "juridical person of another Member" means a juridical person which is either:

(i) constituted or otherwise organized under the law of that other Member, and is engaged in substantive business operations in the territory of that Member or any other Member; or

(ii) in the case of the supply of a service through commercial presence, owned or controlled by:

1. natural persons of that Member; or

2. juridical persons of that other Member identified under subparagraph (i);

(n) A juridical person is:

(i) "owned" by persons of a Member if more than 50 per cent of the equity interest in it is beneficially owned by persons of that Member;

(ii) "controlled" by persons of a Member if such persons have the power to name a majority of its directors or otherwise legally direct its actions;

(iii) "affiliated" with another person when it controls, or is controlled by, that other person; or when it and the other person are both controlled by the same person; and

(o) "direct taxes" comprise all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

Article XXIX
Annexes

The Annexes to this Agreement are an integral part of this Agreement.

ANNEXES

Annex on Article II Exemptions

Scope

1. This Annex specifies the conditions under which a Member, at the entry into force of this Agreement, is exempted from its obligations under paragraph 1 of Article II.

2. Any new exemptions applied for after the date of entry into force of the WTO Agreement shall be dealt with under paragraph 3 of Article IX of that Agreement.

Review

3. The Council for Trade in Services shall review all exemptions granted for a period of more than five years. The first such review shall take place no more than five years after the entry into force of the WTO Agreement.

4. The Council for Trade in Services in a review shall:

(a) examine whether the conditions which created the need for the exemption still prevail; and

(b) determine the date of any further review.

Termination

5. The exemption of a Member from its obligations under paragraph 1 of Article II of the Agreement with respect to a particular measure terminates on the date provided for in the exemption.

6. In principle, such exemptions should not exceed a period of 10 years. In any event, they shall be subject to negotiation in subsequent trade-liberalizing rounds.

7. A Member shall notify the Council for Trade in Services at the termination of the exemption period that the inconsistent measure has been brought into conformity with paragraph 1 of Article II of the Agreement.

Lists of Article II Exemptions

[The agreed lists of exemptions under paragraph 2 of Article II appear as part of this Annex in the treaty copy of the WTO Agreement.]

Annex on Movement of Natural Persons Supplying Services under the Agreement

1. This Annex applies to measures affecting natural persons who are service suppliers of a Member, and natural persons of a Member who are employed by a service supplier of a Member, in respect of the supply of a service.

2. The Agreement shall not apply to measures affecting natural persons seeking access to the employment market of a Member, nor shall it apply to measures regarding citizenship, residence or employment on a permanent basis.

3. In accordance with Parts III and IV of the Agreement, Members may negotiate specific commitments applying to the movement of all categories of natural persons supplying services under the Agreement. Natural persons covered by a specific commitment shall be allowed to supply the service in accordance with the terms of that commitment.

4. The Agreement shall not prevent a Member from applying measures to regulate the entry of natural persons into, or their temporary stay in, its territory, including those necessary to protect the integrity of, and to ensure the orderly movement of natural persons across, its borders, provided that such measures are not applied in such a manner as to nullify or impair the benefits accruing to any Member under the terms of a specific commitment.[13]

Annex on Financial Services

1. *Scope and Definition*

(a) This Annex applies to measures affecting the supply of financial services. Reference to the supply of a financial service in this Annex shall mean the supply of a service as defined in paragraph 2 of Article I of the Agreement.

[13]The sole fact of requiring a visa for natural persons of certain members and not for those of others shall not be regarded as nullifying or impairing benefits under a specific commitment.

(b) For the purposes of subparagraph 3(b) of Article I of the Agreement, "services supplied in the exercise of governmental authority" means the following:

(i) activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies;

(ii) activities forming part of a statutory system of social security or public retirement plans; and

(iii) other activities conducted by a public entity for the account or with the guarantee or using the financial resources of the Government.

(c) For the purposes of subparagraph 3(b) of Article I of the Agreement, if a Member allows any of the activities referred to in subparagraph (b)(ii) or (b)(iii) of this paragraph to be conducted by its financial service suppliers in competition with a public entity or a financial service supplier, "services" shall include such activities.

(d) Subparagraph 3(c) of Article I of the Agreement shall not apply to services covered by this Annex.

2. *Domestic Regulation*

(a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.

(b) Nothing in the Agreement shall be construed to require a Member to disclose information relating to the affairs and accounts of individual customers or any confidential or proprietary information in the possession of public entities.

3. *Recognition*

(a) A Member may recognize prudential measures of any other country in determining how the Member's measures relating to financial services shall be applied. Such recognition, which may be achieved through harmonization or otherwise, may be based upon an agreement or arrangement with the country concerned or may be accorded autonomously.

(b) A Member that is a party to such an agreement or arrangement referred to in subparagraph (a), whether future or existing, shall afford adequate opportunity for other interested Members to negotiate their accession to such agreements or arrangements, or to negotiate comparable ones with it, under circumstances in which there would be equivalent regulation, oversight, implementation of such regulation, and, if appropriate, procedures concerning the sharing of information between the parties to the agreement or arrangement. Where a Member accords recognition autonomously, it shall afford adequate opportunity for any other Member to demonstrate that such circumstances exist.

(c) Where a Member is contemplating according recognition to prudential measures of any other country, paragraph 4(b) of Article VII shall not apply.

4. *Dispute Settlement*

Panels for disputes on prudential issues and other financial matters shall have the necessary expertise relevant to the specific financial service under dispute.

5. *Definitions*

For the purposes of this Annex:

(a) A financial service is any service of a financial nature offered by a financial service supplier of a Member. Financial services include all insurance and insurance-related services, and all banking and other financial services (excluding insurance). Financial services include the following activities:

Insurance and insurance-related services

(i) Direct insurance (including co-insurance):

(A) life

(B) non-life

(ii) Reinsurance and retrocession;

(iii) Insurance intermediation, such as brokerage and agency;

(iv) Services auxiliary to insurance, such as consultancy, actuarial, risk assessment and claim settlement services.

Banking and other financial services (excluding insurance)

(v) Acceptance of deposits and other repayable funds from the public:

(vi) Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction;

(vii) Financial leasing;

(viii) All payment and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts;

(ix) Guarantees and commitments;

(x) Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following:

(A) money market instruments (including cheques, bills, certificates of deposits);

(B) foreign exchange;

(C) derivative products including, but not limited to, futures and options;

(D) exchange rate and interest rate instruments, including products such as swaps, forward rate agreements;

(E) transferable securities;

(F) other negotiable instruments and financial assets, including bullion.

(xi) Participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) and provision of services related to such issues;

(xii) Money broking;

(xiii) Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services;

(xiv) Settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments;

(xv) Provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services;

(xvi) Advisory, intermediation and other auxiliary financial services on all the activities listed in subparagraphs (v) through (xv), including credit reference and analysis,

investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy.

(b) A financial service supplier means any natural or juridical person of a Member wishing to supply or supplying financial services but the term "financial service supplier" does not include a public entity.

(c) "Public entity" means:

(i) a government, a central bank or a monetary authority, of a Member, or an entity owned or controlled by a Member, that is principally engaged in carrying out governmental functions or activities for governmental purposes, not including an entity principally engaged in supplying financial services on commercial terms; or

(ii) a private entity, performing functions normally performed by a central bank or monetary authority, when exercising those functions.

Second Annex on Financial Services

1. Notwithstanding Article II of the Agreement and paragraphs 1 and 2 of the Annex on Article II Exemptions, a Member may, during a period of 60 days beginning four months after the date of entry into force of the WTO Agreement, list in that Annex measures relating to financial services which are inconsistent with paragraph 1 of Article II of the Agreement.

2. Notwithstanding Article XXI of the Agreement, a Member may, during a period of 60 days beginning four months after the date of entry into force of the WTO Agreement, improve, modify or withdraw all or part of the specific commitments on financial services inscribed in its Schedule.

3. The Council for Trade in Services shall establish any procedures necessary for the application of paragraphs 1 and 2.

[The annexes regarding Air Transport Services, Maritime Transport Services, and Telecomunications are omitted.]

Appendix I

1a | Understanding on Commitments in Financial Services

Participants in the Uruguay Round have been enabled to take on specific commitments with respect to financial services under the General Agreement on Trade in Services (hereinafter referred to as the "Agreement") on the basis of an alternative approach to that covered by the provisions of Part III of the Agreement.[1] It was agreed that this approach could be applied subject to the following understanding:

(i) it does not conflict with the provisions of the Agreement;

(ii) it does not prejudice the right of any Member to schedule its specific commitments in accordance with the approach under Part III of the Agreement;

(iii) resulting specific commitments shall apply on a most-favoured-nation basis;

(iv) no presumption has been created as to the degree of liberalization to which a Member is committing itself under the Agreement.

Interested Members, on the basis of negotiations, and subject to conditions and qualifications where specified, have inscribed in their schedule specific commitments conforming to the approach set out below.

A. *Standstill*

Any conditions, limitations and qualifications to the commitments noted below shall be limited to existing non-conforming measures.

B. *Market Access*

Monopoly Rights

1. In addition to Article VIII of the Agreement, the following shall apply:

[1]This text is reproduced with permission from the GATT Secretariat. The Understanding is part of the Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, December 15, 1993, *reprinted in The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts* 478 (1994).

Each Member shall list in its schedule pertaining to financial services existing monopoly rights and shall endeavour to eliminate them or reduce their scope. Notwithstanding subparagraph 1(b) of the Annex on Financial Services, this paragraph applies to the activities referred to in subparagraph 1(b)(iii) of the Annex.

Financial Services Purchased by Public Entities

2. Notwithstanding Article XIII of the Agreement, each Member shall ensure that financial service suppliers of any other Member established in its territory are accorded most-favoured-nation treatment and national treatment as regards the purchase or acquisition of financial services by public entities of the Member in its territory.

Cross-Border Trade

3. Each Member shall permit non-resident suppliers of financial services to supply, as a principal, through an intermediary or as an intermediary, and under terms and conditions that accord national treatment, the following services:

(a) insurance of risks relating to:

(i) maritime shipping and commercial aviation and space launching and freight (including satellites), with such insurance to cover any or all of the following: the goods being transported, the vehicle transporting the goods and any liability arising therefrom; and

(ii) goods in international transit;

(b) reinsurance and retrocession and the services auxiliary to insurance as referred to in subparagraph 5(a)(iv) of the Annex;

(c) provision and transfer of financial information and financial data processing as referred to in subparagraph 5(a)(xv) of the Annex and advisory and other auxiliary services, excluding intermediation, relating to banking and other financial services as referred to in subparagraph 5(a)(xvi) of the Annex.

4. Each Member shall permit its residents to purchase in the territory of another Member the financial services indicated in:

(a) subparagraph 3(a);

(b) subparagraph 3(b); and

(c) subparagraphs 5(a)(v) to (xvi) of the Annex.

Commercial Presence

5. Each Member shall grant financial service suppliers of any other Member the right to establish or expand within its territory, including through the acquisition of existing enterprises, a commercial presence.

6. A Member may impose terms, conditions and procedures for authorization of the establishment and expansion of a commercial presence in so far as they do not circumvent the Member's obligation under paragraph 5 and they are consistent with the other obligations of this Agreement.

New Financial Services

7. A Member shall permit financial service suppliers of any other Member established in its territory to offer in its territory any new financial service.

Transfers of Information and Processing of Information

8. No Member shall take measures that prevent transfers of information or the processing of financial information, including transfers of data by electronic means, or that, subject to importation rules consistent with international agreements, prevent transfers of equipment, where such transfers of information, processing of financial information or transfers of equipment are necessary for the conduct of the ordinary business of a financial service supplier. Nothing in this paragraph restricts the right of a Member to protect personal data, personal privacy and the confidentiality of individual records and accounts so long as such right is not used to circumvent the provisions of the Agreement.

Temporary Entry of Personnel

9. (a) Each Member shall permit temporary entry into its territory of the following personnel of a financial service supplier of any other Member that is establishing or has established a commercial presence in the territory of the Member:

   (i) senior managerial personnel possessing proprietary information essential to the establishment, control and operation of the services of the financial service supplier; and

   (ii) specialists in the operation of the financial service supplier.

   (b) Each Member shall permit, subject to the availability of qualified personnel in its territory, temporary entry into its territory of the following personnel associated with a commercial presence of a financial service supplier of any other Member:

(i) specialists in computer services, telecommunications services, and accounts of the financial service supplier; and

(ii) actuarial and legal specialists.

Non-discriminatory Measures

10. Each Member shall endeavour to remove or to limit any significant adverse effects on financial service suppliers of any other Member of:

(a) non-discriminatory measures that prevent financial service suppliers from offering in the Member's territory, in the form determined by the Member, all the financial services permitted by the Member;

(b) non-discriminatory measures that limit the expansion of the activities of financial service suppliers into the entire territory of the Member;

(c) measures of a Member, when such a Member applies the same measures to the supply of both banking and securities services, and a financial service supplier of any other Member concentrates its activities in the provision of securities services; and

(d) other measures that, although respecting the provisions of the Agreement, affect adversely the ability of financial service suppliers of any other Member to operate, compete or enter the Member's market;

provided that any action taken under this paragraph would not unfairly discriminate against financial service suppliers of the Member taking such action.

11. With respect to the non-discriminatory measures referred to in subparagraphs 10(a) and (b), a Member shall endeavour not to limit or restrict the present degree of market opportunities nor the benefits already enjoyed by financial service suppliers of all other Members as a class in the territory of the Member, provided that this commitment does not result in unfair discrimination against financial service suppliers of the Member applying such measures.

C. *National Treatment*

1. Under terms and conditions that accord national treatment, each Member shall grant to financial service suppliers of any other Member established in its territory access to payment and clearing systems operated by public entities, and to official funding and refinancing facilities

available in the normal course of ordinary business. This paragraph is not intended to confer access to the Member's lender of last resort facilities.

2. When membership or participation in, or access to, any self-regulatory body, securities or futures exchanges or market, clearing agency, or any other organization or association, is required by a Member in order for financial service suppliers of any other Member to supply financial services on an equal basis with financial service suppliers of the Member, or when the Member provides directly or indirectly such entities, privileges or advantages in supplying financial services, the Member shall ensure that such entities accord national treatment to financial service suppliers of any other Member resident in the territory of the Member.

D. *Definitions*

For the purposes of this approach:

1. A non-resident supplier of financial services is a financial service supplier of a Member which supplies a financial service into the territory of another Member from an establishment located in the territory of another Member, regardless of whether such a financial service supplier has or has not a commercial presence in the territory of the Member in which the financial service is supplied.

2. "Commercial presence" means an enterprise within a Member's territory for the supply of financial services and includes wholly- or partly-owned subsidiaries, joint ventures, partnerships, sole proprietorships, franchising operations, branches, agencies, representative offices or other organizations.

3. A new financial service is a service of a financial nature, including services related to existing and new products or the manner in which a product is delivered, that is not supplied by any financial service supplier in the territory of a particular Member but which is supplied in the territory of another Member.

Appendix I

2 North American Free Trade Agreement

[Selected Provisions][1]

Chapter Eleven

Investment

Section A - Investment

* * * * *

Article 1109: Transfers

1. Each Party shall permit all transfers relating to an investment of an investor of another Party in the territory of the Party to be made freely and without delay. Such transfers include:

(a) profits, dividends, interest, capital gains, royalty payments, management fees, technical assistance and other fees, returns in kind and other amounts derived from the investment;

(b) proceeds from the sale of all or any part of the investment or from the partial or complete liquidation of the investment;

(c) payments made under a contract entered into by the investor, or its investment, including payments made pursuant to a loan agreement;

(d) payments made pursuant to Article 1110; and

(e) payments arising under Section B.

2. Each Party shall permit transfers to be made in a freely usable currency at the market rate of exchange prevailing on the date of transfer with respect to spot transactions in the currency to be transferred.

3. No Party may require its investors to transfer, or penalize its investors that fail to transfer, the income, earnings, profits or other amounts derived from, or attributable to, investments in the territory of another Party.

[1] December 8, 11, 14, and 17, 1992, Canada - Mexico - United States.

4. Notwithstanding paragraphs 1 and 2, a Party may prevent a transfer through the equitable, non-discriminatory and good faith application of its laws relating to:

(a) bankruptcy, insolvency or the protection of the rights of creditors;

(b) issuing, trading or dealing in securities;

(c) criminal or penal offenses;

(d) reports of transfers of currency or other monetary instruments; or

(e) ensuring the satisfaction of judgments in adjudicatory proceedings.

5. Paragraph 3 shall not be construed to prevent a Party from imposing any measure through the equitable, non-discriminatory and good faith application of its laws relating to the matters set out in subparagraphs (a) through (e) of paragraph 4.

6. Notwithstanding paragraph 1, a Party may restrict transfers of returns in kind in circumstances where it could otherwise restrict such transfers under this Agreement, including as set out in paragraph 4.

Article 1110: Expropriation and Compensation

1. No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except:

(a) for a public purpose;

(b) on a non-discriminatory basis;

(c) in accordance with due process of law and Article 1105(1); and

(d) on payment of compensation in accordance with paragraphs 2 through 6.

2. Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriation took place ("date of expropriation"), and shall not reflect any change in value occurring because the intended expropriation had become known earlier. Valuation criteria shall include going concern value, asset value including declared tax value of tangible property, and other criteria, as appropriate, to determine fair market value.

3. Compensation shall be paid without delay and be fully realizable.

4. If payment is made in a G7 currency, compensation shall include interest at a commercially reasonable rate for that currency from the date of expropriation until the date of actual payment.

5. If a Party elects to pay in a currency other than a G7 currency, the amount paid on the date of payment, if converted into a G7 currency at the market rate of exchange prevailing on that date, shall be no less than if the amount of compensation owed on the date of expropriation had been converted into that G7 currency at the market rate of exchange prevailing on that date, and interest had accrued at a commercially reasonable rate for that G7 currency from the date of expropriation until the date of payment.

6. On payment, compensation shall be freely transferable as provided in Article 1109.

7. This Article does not apply to the issuance of compulsory licenses granted in relation to intellectual property rights, or to the revocation, limitation or creation of intellectual property rights, to the extent that such issuance, revocation, limitation or creation is consistent with Chapter Seventeen (Intellectual Property).

8. For purposes of this Article and for greater certainty, a non-discriminatory measure of general application shall not be considered a measure tantamount to an expropriation of a debt security or loan covered by this Chapter solely on the ground that the measure imposes costs on the debtor that cause it to default on the debt.

Article 1111: Special Formalities and Information Requirements

1. Nothing in Article 1102 shall be construed to prevent a Party from adopting or maintaining a measure that prescribes special formalities in connection with the establishment of investments by investors of another Party, such as a requirement that investors be residents of the Party or that investments be legally constituted under the laws or regulations of the Party, provided that such formalities do not materially impair the protections afforded by a Party to investors of another Party and investments of investors of another Party pursuant to this Chapter.

2. Notwithstanding Article 1102 or 1103, a Party may require an investor of another Party, or its investment in its territory, to provide routine information concerning that investment solely for informational or statistical purposes. The Party shall protect such business information that is confidential from any disclosure that would prejudice the competitive position of the investor or the investment. Nothing in this paragraph shall be construed to prevent a Party from otherwise obtaining or dis-

closing information in connection with the equitable and good faith application of its law.

* * * * *

Article 1113: Denial of Benefits

1. A Party may deny the benefits of this Chapter to an investor of another Party that is an enterprise of such Party and to investments of such investor if investors of a non-Party own or control the enterprise and the denying Party:

(a) does not maintain diplomatic relations with the non-Party; or

(b) adopts or maintains measures with respect to the non-Party that prohibit transactions with the enterprise or that would be violated or circumvented if the benefits of this Chapter were accorded to the enterprise or to its investments.

2. Subject to prior notification and consultation in accordance with Article 1803 (Notification and Provision of Information) and 2006 (Consultations), a Party may deny the benefits of this Chapter to an Investor of another Party that is an enterprise of such Party and to investments of such investors if investors of a non-Party own or control the enterprise and the enterprise has no substantial business activities in the territory of the Party under whose law it is constituted or organized.

Article 1114: Environmental Measures

1. Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns.

2. The Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor. If a Party considers that another Party has offered such an encouragement, it may request consultation with the other Party and the two Parties shall consult with a view to avoiding any such encouragement.

Section B - Settlement of Disputes between a Party and an Investor of Another Party

Article 1115: Purpose

Without prejudice to the rights and obligations of the Parties under Chapter Twenty (Institutional Arrangements and Dispute Settlement Procedure), this Section establishes a mechanism for the settlement of investment disputes that assures both equal treatment among the investors of the Parties in accordance with the principle of international reciprocity and due process before an impartial tribunal.

Article 1116: Claim by an Investor of a Party on Its Own Behalf

1. An investor of a Party may submit to arbitration under this Section a claim that another Party has breached an obligation under:

(a) Section A or Article 1503(2) (State Enterprises), or

(b) Article 1502(3)(a) (Monopolies and State Enterprises) where the monopoly has acted in a manner inconsistent with the Party's obligations under Section A,

and that the investor has incurred loss or damage by reason of, or arising out of, that breach.

2. An investor may not make a claim if more than three years have elapsed from the date on which the investor first acquired, or should have first acquired, knowledge of the alleged breach and knowledge that the investor has incurred loss or damage.

Article 1117: Claim by an Investor of a Party on Behalf of an Enterprise

1. An investor of a Party, on behalf of an enterprise of another Party that is a juridical person that the investor owns or controls directly or indirectly, may submit to arbitration under this Section a claim that the other Party has breached an obligation under:

(a) Section A or Article 1503(2) (State Enterprises), or

(b) Article 1502(3)(a) (Monopolies and State Enterprises) where the monopoly has acted in a manner inconsistent with the Party's obligations under Section A,

and that the enterprise has incurred loss or damage by reason of, or arising out of, that breach.

2. An investor may not make a claim on behalf of an enterprise described in paragraph 1 if more than three years have elapsed from the date on which the enterprise first acquired, or should have first acquired, knowledge of the alleged breach and knowledge that the enterprise has incurred loss or damage.

3. Where an investor makes a claim under this Article and the investor or a noncontrolling investor in the enterprise makes a claim under Article 1116 arising out of the same events that gave rise to the claim under this Article, and two or more of the claims are submitted to arbitration under Article 1120, the claims should be heard together by a Tribunal established under Article 1126, unless the Tribunal finds that the interests of a disputing party would be prejudiced thereby.

4. An investment may not make a claim under this Section.

Article 1118: Settlement of a Claim through Consultation and Negotiation

The disputing parties should first attempt to settle a claim through consultation or negotiation.

Article 1119: Notice of Intent to Submit a Claim to Arbitration

The disputing investor shall deliver to the disputing Party written notice of its intention to submit a claim to arbitration at least 90 days before the claim is submitted, which notice shall specify:

(a) the name and address of the disputing investor and, where a claim is made under Article 1117, the name and address of the enterprise;

(b) the provisions of this Agreement alleged to have been breached and any other relevant provisions;

(c) the issues and the factual basis for the claim; and

(d) the relief sought and the approximate amount of damages claimed.

Article 1120: Submission of a Claim to Arbitration

1. Except as provided in Annex 1120.1, and provided that six months have elapsed since the events giving rise to a claim, a disputing investor may submit the claim to arbitration under:

(a) the ICSID Convention, provided that both the disputing Party and the Party of the investor are parties to the Convention;

(b) the Additional Facility Rules of ICSID, provided that either the disputing Party or the Party of the investor, but not both, is a party to the ICSID Convention; or

(c) the UNCITRAL Arbitration Rules.

2. The applicable arbitration rules shall govern the arbitration except to the extent modified by this Section.

Article 1121: Conditions Precedent to Submission of a Claim to Arbitration

1. A disputing investor may submit a claim under Article 1116 to arbitration only if:

(a) the investor consents to arbitration in accordance with the procedures set out in this Agreement; and

(b) the investor and, where the claim is for loss or damage to an interest in an enterprise of another Party that is a juridical person that the investor owns or controls directly or indirectly, the enterprise, waive their right to initiate or continue before any administrative tribunal or court under the law of any Party, or other dispute settlement procedures, any proceedings with respect to the measure of the disputing Party that is alleged to be a breach referred to in Article 1116, except for proceedings for injunctive, declaratory or other extraordinary relief, not involving the payment of damages, before an administrative tribunal or court under the law of the disputing Party.

2. A disputing investor may submit a claim under Article 1117 to arbitration only if both the investor and the enterprise:

(a) consent to arbitration in accordance with the procedures set out in this Agreement; and

(b) waive their right to initiate or continue before any administrative tribunal or court under the law of any Party, or other dispute settlement procedures, any proceedings with respect to the measure of the disputing Party that is alleged to be a breach referred to in Article 1117, except for proceedings for injunctive, declaratory or other extraordinary relief, not involving the payment of damages, before an administrative tribunal or court under the law of the disputing Party.

3. A consent and waiver required by this Article shall be in writing, shall be delivered to the disputing Party and shall be included in the submission of a claim to arbitration.

4. Only where a disputing Party has deprived a disputing investor of control of an enterprise:

(a) a waiver from the enterprise under paragraph 1(b) or 2(b) shall not be required; and

(b) Annex 1120.1(A)(b) shall not apply.

Article 1122: Consent to Arbitration

1. Each Party consents to the submission of a claim to arbitration in accordance with the procedures set out in this Agreement.

2. The consent given by paragraph 1 and the submission by a disputing investor of a claim to arbitration shall satisfy the requirement of:

(a) Chapter II of the ICSID Convention (Jurisdiction of the Centre) and the Additional Facility Rules for written consent of the Parties;

(b) Article II of the New York Convention for an agreement in writing; and

(c) Article I of the Inter-American Convention for an agreement.

Article 1123: Number of Arbitrators and Method of Appointment

Except in respect of a Tribunal established under Article 1126, and unless the disputing Parties otherwise agree, the Tribunal shall comprise three arbitrators, one arbitrator appointed by each of the disputing parties and the third, who shall be the presiding arbitrator, appointed by agreement of the disputing Parties.

Article 1124: Constitution of a Tribunal When a Party Fails to Appoint an Arbitrator or the Disputing Parties Are Unable to Agree on a Presiding Arbitrator

1. The Secretary-General shall serve as appointing authority for an arbitration under this Section.

2. If a Tribunal, other than a Tribunal established under Article 1126, has not been constituted within 90 days from the date that a claim is submitted to arbitration, the Secretary-General, on the request of either disputing Party, shall appoint, in his discretion, the arbitrator or arbitrators not yet appointed, except that the presiding arbitrator shall be appointed in accordance with paragraph 3.

3. The Secretary-General shall appoint the presiding arbitrator from the roster of presiding arbitrators referred to in paragraph 4, provided

that the presiding arbitrator shall not be a national of the disputing Party or a national of the Party of the disputing investor. In the event that no such presiding arbitrator is available to serve, the Secretary-General shall appoint, from the ICSID Panel of Arbitrators, a presiding arbitrator who is not a national of any of the Parties.

4. On the date of entry into force of this Agreement, the Parties shall establish, and thereafter maintain, a roster of 45 presiding arbitrators meeting the qualifications of the Convention and rules referred to in Article 1120 and experienced in international law and investment matters. The roster members shall be appointed by consensus and without regard to nationality.

Article 1125: Agreement to Appointment of Arbitrators

For purposes of Article 39 of the ICSID Convention and Article 7 of Schedule C to the ICSID Additional Facility Rules, and without prejudice to an objection to an arbitrator based on Article 1124(3) or on a ground other than nationality:

(a) the disputing Party agrees to the appointment of each individual member of a Tribunal established under the ICSID Convention or the ICSID Additional Facility Rules;

(b) a disputing investor referred to in Article 1116 may submit a claim to arbitration, or continue a claim, under the ICSID Convention or the ICSID Additional Facility Rules, only on condition that the disputing investor agrees in writing to the appointment of each individual member of the Tribunal; and

(c) a disputing investor referred to in Article 1117(1) may submit a claim to arbitration, or continue a claim, under the ICSID Convention or the ICSID Additional Facility Rules, only on condition that the disputing investor and the enterprise agree in writing to the appointment of each individual member of the Tribunal.

Article 1126: Consolidation

1. A Tribunal established under this Article shall be established under the UNCITRAL Arbitration Rules and shall conduct its proceedings in accordance with those Rules, except as modified by this Section.

2. Where a Tribunal established under this Article is satisfied that claims have been submitted to arbitration under Article 1120 that have a question of law or fact in common, the Tribunal may, in the interests of

fair and efficient resolution of the claims, and after hearing the disputing Parties, by order:

(a) assume jurisdiction over, and hear and determine together, all or part of the claims; or

(b) assume jurisdiction over, and hear and determine one or more of the claims, the determination of which it believes would assist in the resolution of the others.

3. A disputing Party that seeks an order under paragraph 2 shall request the Secretary-General to establish a Tribunal and shall specify in the request:

(a) the name of the disputing Party or disputing investors against which the order is sought;

(b) the nature of the order sought; and

(c) the grounds on which the order is sought.

4. The disputing Party shall deliver to the disputing Party or disputing investors against which the order is sought a copy of the request.

5. Within 60 days of receipt of the request, the Secretary-General shall establish a Tribunal comprising three arbitrators. The Secretary-General shall appoint the presiding arbitrator from the roster referred to in Article 1124(4). In the event that no such presiding arbitrator is available to serve, the Secretary-General shall appoint, from the ICSID Panel of Arbitrators, a presiding arbitrator who is not a national of any of the Parties. The Secretary-General shall appoint the two other members from the roster referred to in Article 1124(4), and to the extent not available from that roster, from the ICSID Panel of Arbitrators, and to the extent not available from that Panel, in the discretion of the Secretary-General. One member shall be a national of the disputing Party and one member shall be a national of a Party of the disputing investors.

6. Where a Tribunal has been established under this Article, a disputing investor that has submitted a claim to arbitration under Article 1116 or 1117 and that has not been named in a request made under paragraph 3 may make a written request to the Tribunal that it be included in an order made under paragraph 2, and shall specify in the request:

(a) the name and address of the disputing investor;

(b) the nature of the order sought; and

(c) the grounds on which the order is sought.

7. A disputing investor referred to in paragraph 6 shall deliver a copy of its request to the disputing Parties named in a request made under paragraph 3.

8. A Tribunal established under Article 1120 shall not have jurisdiction to decide a claim, or a part of a claim, over which a Tribunal established under this Article has assumed jurisdiction.

9. On application of a disputing Party, a Tribunal established under this Article, pending its decision under paragraph 2, may order that the proceedings of a Tribunal established under Article 1120 be stayed, unless the latter Tribunal has already adjourned its proceedings.

10. A disputing Party shall deliver to the Secretariat, within 15 days of receipt by the disputing Party, a copy of:

(a) a request for arbitration made under paragraph (1) of Article 36 of the ICSID Convention;

(b) a notice of arbitration made under Article 2 of Schedule C of the ICSID Additional Facility Rules; or

(c) a notice of arbitration given under the UNCITRAL Arbitration Rules.

11. A disputing Party shall deliver to the Secretariat a copy of a request made under paragraph 3:

(a) within 15 days of receipt of the request, in the case of a request made by a disputing investor;

(b) within 15 days of making the request, in the case of a request made by the disputing Party.

12. A disputing Party shall deliver to the Secretariat a copy of a request made under paragraph 6 within 15 days of receipt of the request.

13. The Secretariat shall maintain a public register of the documents referred to in paragraphs 10, 11, and 12.

Article 1127: Notice

A disputing Party shall deliver to the other Parties:

(a) written notice of a claim that has been submitted to arbitration no later than 30 days after the date that the claim is submitted; and

(b) copies of all pleadings filed in the arbitration.

Article 1128: Participation by a Party

On written notice to the disputing parties, a Party may make submissions to a Tribunal on a question of interpretation of this Agreement.

Article 1129: Documents

1. A Party shall be entitled to receive from the disputing Party, at the cost of the requesting Party a copy of:

(a) the evidence that has been tendered to the Tribunal; and

(b) the written argument of the disputing parties.

2. A Party receiving information pursuant to paragraph 1 shall treat the information as if it were a disputing Party.

Article 1130: Place of Arbitration

Unless the disputing Parties agree otherwise, a Tribunal shall hold an arbitration in the territory of a Party that is a Party to the New York Convention, selected in accordance with:

(a) the ICSID Additional Facility Rules if the arbitration is under those Rules or the ICSID Convention; or

(b) the UNCITRAL Arbitration Rules if the arbitration is under those Rules.

Article 1131: Governing Law

1. A Tribunal established under this Section shall decide the issues in dispute in accordance with this Agreement and applicable rules of international law.

2. An interpretation by the Commission of a provision of this Agreement shall be binding on a Tribunal established under this Section.

Article 1132: Interpretation of Annexes

1. Where a disputing Party asserts as a defense that the measure alleged to be a breach is within the scope of a reservation or exception set out in Annex I, Annex II, Annex III or Annex IV, on request of the disputing Party, the Tribunal shall request the interpretation of the Commission on the issue. The Commission, within 60 days of delivery of the request, shall submit in writing its interpretation to the Tribunal.

2. Further to Article 1131(2), a Commission interpretation submitted under paragraph 1 shall be binding on the Tribunal. If the Commission

fails to submit an interpretation within 60 days, the Tribunal shall decide the issue.

Article 1133: Expert Reports

Without prejudice to the appointment of other kinds of experts where authorized by the applicable arbitration rules, a Tribunal, at the request of a disputing Party or, unless the disputing parties disapprove, on its own initiative, may appoint one or more experts to report to it in writing on any factual issue concerning environmental, health, safety or other scientific matters raised by a disputing Party in a proceeding, subject to such terms and conditions as the disputing Parties may agree.

Article 1134: Interim Measures of Protection

A Tribunal may order an interim measure of protection to preserve the rights of a disputing party, or to ensure that the Tribunal's jurisdiction is made fully effective, including an order to preserve evidence in the possession or control of a disputing party or to protect the Tribunal's jurisdiction. A Tribunal may not order attachment or enjoin the application of the measure alleged to constitute a breach referred to in Article 1116 or 1117. For purposes of this paragraph, an order includes a recommendation.

Article 1135: Final Award

1. Where a Tribunal makes a final award against a Party, the Tribunal may award, separately or in combination, only:

   (a) monetary damages and any applicable interest;

   (b) restitution of property, in which case the award shall provide that the disputing Party may pay monetary damages and any applicable interest in lieu of restitution.

A tribunal may also award costs in accordance with the applicable arbitration rules.

2. Subject to paragraph 1, where a claim is made under Article 1117(1):

   (a) an award of restitution of property shall provide that restitution be made to the enterprise;

   (b) an award of monetary damages and any applicable interest shall provide that the sum be paid to the enterprise; and

   (c) the award shall provide that it is made without prejudice to any right that any person may have in the relief under applicable domestic law.

3. A Tribunal may not order a Party to pay punitive damages.

Article 1136: Finality and Enforcement of an Award

1. An award made by a Tribunal shall have no binding force except between the disputing Parties and in respect of the particular case.

2. Subject to paragraph 3 and the applicable review procedure for an interim award, a disputing Party shall abide by and comply with an award without delay.

3. A disputing party may not seek enforcement of a final award until:

(a) in the case of a final award made under the ICSID Convention

(i) 120 days have elapsed from the date the award was rendered and no disputing Party has requested revision or annulment of the award, or

(ii) revision or annulment proceedings have been completed; and

(b) in the case of a final award under the ICSID Additional Facility Rules or the UNCITRAL Arbitration Rules

(i) three months have elapsed from the date the award was rendered and no disputing Party has commenced a proceeding to revise, set aside or annul the award, or

(ii) a court has dismissed or allowed an application to revise, set aside or annul the award and there is no further appeal.

4. Each Party shall provide for the enforcement of an award in its territory.

5. If a disputing Party fails to abide by or comply with a final award, the Commission, on delivery of a request by a Party whose investor was a Party to the arbitration, shall establish a panel under Article 2008 (Request for an Arbitral Panel). The requesting Party may seek in such proceedings:

(a) a determination that the failure to abide by or comply with the final award is inconsistent with the obligations of this Agreement; and

(b) a recommendation that the Party abide by or comply with the final award.

6. A disputing investor may seek enforcement of an arbitration award under the ICSID Convention, the New York Convention or the Inter-

American Convention regardless of whether proceedings have been taken under paragraph 5.

7. A claim that is submitted to arbitration under this Section shall be considered to arise out of a commercial relationship or transaction for purposes of Article I of the New York Convention and Article I of the Inter-American Convention.

Article 1137: General

Time When a Claim Is Submitted to Arbitration

1. A claim is submitted to arbitration under this Section when:

   (a) the request for arbitration under paragraph 1 of Article 36 of the ICSID Convention has been received by the Secretary-General;

   (b) the notice of arbitration under Article 2 of Schedule C of the ICSID Additional Facility Rules has been received by the Secretary-General; or

   (c) the notice of arbitration given under the UNCITRAL Arbitration Rules is received by the disputing Party.

Service of Documents

2. Delivery of notice and other documents on a Party shall be made to the place named for that Party in Annex 1137.2.

Receipts under Insurance or Guarantee Contracts

3. In an arbitration under this Section, a Party shall not assert, as a defense, counterclaim, right of setoff or otherwise, that the disputing investor has received or will receive, pursuant to an insurance or guarantee contract, indemnification or other compensation for all or part of its alleged damages.

Publication of an Award

4. Annex 1137.4 applies to the Parties specified in that Annex with respect to publication of an award.

Article 1138: Exclusions

1. Without prejudice to the applicability or non-applicability of the dispute settlement provisions of this Section or of Chapter Twenty (Institutional Arrangements and Dispute Settlement Procedure) to other actions taken by a Party pursuant to Article 2102 (National Security), a decision by a Party to prohibit or restrict the acquisition of an investment

in its territory by an investor of another Party, or its investment, pursuant to that Article shall not be subject to such provisions.

2. The dispute settlement provisions of this Section and of Chapter Twenty shall not apply to the matters referred to in Annex 1138.2.

* * * * *

Chapter Twelve

Cross-Border Trade in Services

* * * * *

Article 1211: Denial of Benefits

1. A Party may deny the benefits of this Chapter to a service provider of another Party where the Party establishes that:

(a) the denying Party is being provided by an enterprise owned or controlled by nationals of a non-Party, and

(i) the denying Party does not maintain diplomatic relations with the non-Party, or

(ii) the denying Party adopts or maintains measures with respect to the non-Party that prohibit transactions with the enterprise or that would be violated or circumvented if the benefits of this Chapter were accorded to the enterprise; or

(b) the cross-border provision of a transportation service covered by this Chapter is provided using equipment not registered by any Party.

2. Subject to prior notification and consultation in accordance with Articles 1803 (Notification and Provision of Information) and 2006 (Consultations), a Party may deny the benefits of this Chapter to a service provider of another Party where the Party establishes that the service is being provided by an enterprise that is owned or controlled by persons of a non-Party and that has no substantial business activities in the territory of any Party.

* * * * *

Chapter Fourteen

Financial Services

Article 1401: Scope and Coverage

1. This Chapter applies to measures adopted or maintained by a Party relating to:

(a) financial institutions of another Party;

(b) investors of another Party, and investments of such investors, in financial institutions in the Party's territory; and

(c) cross-border trade in financial services.

2. Articles 1109 through 1111, 1113, 1114 and 1211 are hereby incorporated into and made a part of this Chapter. Articles 1115 through 1138 are hereby incorporated into and made a part of this Chapter solely for breaches by a Party of Articles 1109 through 1111, 1113, and 1114, as incorporated into this Chapter.

3. Nothing in this Chapter shall be construed to prevent a Party, including its public entities, from exclusively conducting or providing in its territory:

(a) activities or services forming part of a public retirement plan or statutory system of social security; or

(b) activities or services for the account or with the guarantee or using the financial resources of the Party, including its public entities.

4. Annex 1401.4 applies to the Parties specified in that Annex.

Article 1402: Self-Regulatory Organizations

Where a Party requires a financial institution or a cross-border financial service provider of another Party to be a member of, participate in, or have access to, a self-regulatory organization to provide a financial service in or into the territory of that Party, the Party shall ensure observance of the obligations of this Chapter by such self-regulatory organization.

Article 1403: Establishment of Financial Institutions

1. The Parties recognize the principle that an investor of another Party should be permitted to establish a financial institution in the territory of a Party in the juridical form chosen by such investor.

2. The Parties also recognize the principle that an investor of another Party should be permitted to participate widely in a Party's market through the ability of such investor to:

(a) provide in that Party's territory a range of financial services through separate financial institutions as may be required by that Party;

(b) expand geographically in that Party's territory; and

(c) own financial institutions in that Party's territory without being subject to ownership requirements specific to foreign financial institutions.

3. Subject to Annex 1403.3, at such time as the United States permits commercial banks of another Party located in its territory to expand through subsidiaries or direct branches into substantially all of the United States market, the Parties shall review and assess market access provided by each Party in relation to the principles in paragraphs 1 and 2 with a view to adopting arrangements permitting investors of another Party to choose the juridical form of establishment of commercial banks.

4. Each Party shall permit an investor of another Party that does not own or control a financial institution in the Party's territory to establish a financial institution in that territory. A Party may:

(a) require an investor of another Party to incorporate under the Party's law any financial institution it establishes in the Party's territory; or

(b) impose terms and conditions on establishment that are consistent with Article 1405.

5. For purposes of this Article, "investor of another Party" means an investor of another Party engaged in the business of providing financial services in the territory of that Party.

Article 1404: Cross-Border Trade

1. No Party may adopt any measure restricting any type of cross-border trade in financial services by cross-border financial service providers of another Party that the Party permits on the date of entry into force of this Agreement, except to the extent set out in Section B of the Party's Schedule to Annex VII.

2. Each Party shall permit persons located in its territory, and its nationals wherever located to purchase financial services from cross-border financial service providers of another Party located in the territory of that other Party or of another Party. This obligation does not

require a Party to permit such providers to do business or solicit in its territory. Subject to paragraph 1, each Party may define "doing business" and "solicitation" for purposes of this obligation.

3. Without prejudice to other means of prudential regulation of cross-border trade in financial services, a Party may require the registration of cross-border financial service providers of another Party and of financial instruments.

4. The Parties shall consult on the future liberalization of cross-border trade in financial services as set out in Annex 1404.4.

Article 1405: National Treatment

1. Each Party shall accord to investors of another Party treatment no less favorable than that it accords to its own investors, in like circumstances, with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of financial institutions and investments in financial institutions in its territory.

2. Each Party shall accord to financial institutions of another Party and to investments of investors of another Party in financial institutions treatment no less favorable than that it accords to its own financial institutions and to investments of its own investors in financial institutions, in like circumstances, with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of financial institutions and investments.

3. Subject to Article 1404, where a Party permits the cross-border provision of a financial service it shall accord to the cross-border financial service providers of another Party treatment no less favorable than that it accords to its own financial service providers, in like circumstances, with respect to the provision of such service.

4. The treatment that a Party is required to accord under paragraphs 1, 2, and 3 means, with respect to a measure of any state or province:

(a) in the case of an investor of another Party with an investment in a financial institution, an investment of such investor in a financial institution, or a financial institution of such investor, located in a state or province, treatment no less favorable than the treatment accorded to an investor of the Party in a financial institution, an investment of such investor in a financial institution, or a financial institution of such investor, located in that state or province, in like circumstances; and

(b) in any other case, treatment no less favorable than the most favorable treatment accorded to an investor of the Party in a

financial institution, its financial institution or its investment in a financial institution in like circumstances.

For greater certainty, in the case of an investor of another Party with investments in financial institutions or financial institutions of such investor, located in more than one state or province, the treatment required under subparagraph (a) means:

(c) treatment of the investor that is no less favorable than the most favorable treatment accorded to an investor of the Party with an investment located in such states, in like circumstances; and

(d) with respect to an investment of the investor in a financial institution or a financial institution of such investor, located in a state or province, treatment no less favorable than that accorded to an investment of an investor of the Party, or a financial institution of such investor, located in that state or province, in like circumstances.

5. A Party's treatment of financial institutions and cross-border financial service providers of another Party, whether different or identical to that accorded to its own institutions or providers in like circumstances, is consistent with paragraphs 1 through 3 if the treatment affords equal competitive opportunities.

6. A Party's treatment affords equal competitive opportunities if it does not disadvantage financial institutions and cross-border financial service providers of another Party in their ability to provide financial services as compared with the ability of the Party's own financial institutions and financial services providers to provide such services, in like circumstances.

7. Differences in market share, profitability or size do not in themselves establish a denial of equal competitive opportunities, but such differences may be used as evidence regarding whether a Party's treatment affords equal competitive opportunities.

Article 1406: Most-Favored-Nation Treatment

1. Each Party shall accord to investors of another Party, financial institutions of another Party, investments of investors in financial institutions and cross-border financial service providers of another Party treatment no less favorable than that it accords to the investors, financial institutions, investments of investors in financial institutions and cross-border financial service providers of any other Party or of a non-Party, in like circumstances.

2. A Party may recognize prudential measures of another Party or of a non-Party in the application of measures covered by this Chapter. Such recognition may be:

(a) accorded unilaterally;

(b) achieved through harmonization or other means; or

(c) based upon an agreement or arrangement with the other Party or non-Party.

3. A Party according recognition of prudential measures under paragraph 2 shall provide adequate opportunity to another Party to demonstrate that circumstances exist in which there are or would be equivalent regulation, oversight, implementation of regulation, and if appropriate, procedures concerning the sharing of information between the Parties.

4. Where a Party accords recognition of prudential measures under paragraph 2(c) and the circumstances set out in paragraph 3 exist, the Party shall provide adequate opportunity to another Party to negotiate accession to the agreement or arrangement, or to negotiate a comparable agreement or arrangement.

Article 1407: New Financial Services and Data Processing

1. Each Party shall permit a financial institution of another Party to provide any new financial service of a type similar to those services that the Party permits its own financial institutions, in like circumstances, to provide under its domestic law. A Party may determine the institutional and juridical form through which the service may be provided and may require authorization for the provision of the service. Where such authorization is required, a decision shall be made within a reasonable time and the authorization may only be refused for prudential reasons.

2. Each party shall permit a financial institution of another Party to transfer information in electronic or other form, into and out of the Party's territory, for data processing where such processing is required in the ordinary course of business of such an institution.

Article 1408: Senior Management and Boards of Directors

1. No Party may require financial institutions of another Party to engage individuals of any particular nationality as senior managerial or other essential personnel.

2. No Party may require that more than a simple majority of the board of directors of a financial institution of another Party be composed of nationals of the Party, persons residing in the territory of the Party, or a combination thereof.

Article 1409: Reservations and Specific Commitments

1. Articles 1403 through 1408 do not apply to:

(a) Any existing non-conforming measure that is maintained by

(i) a Party at the federal level, as set out in Section A of its Schedule to Annex VII,

(ii) a state or province, for the period ending on the date specified in Annex 1409.1 for that state or province, and thereafter as described by the Party in Section A of its Schedule to Annex VII in accordance with Annex 1409.1, or

(iii) a local government;

(b) the continuation or prompt renewal of any non-conforming measure referred to in subparagraph (a); or

(c) an amendment to any non-conforming measure referred to in subparagraph (a) to the extent that the amendment does not decrease the conformity of the measure, as it existed before the amendment, with Articles 1403 through 1408.

2. Articles 1403 through 1408 do not apply to any non-conforming measure that a Party adopts or maintains in accordance with Section B of its Schedule to Annex VII.

3. Section C of each Party's Schedule to Annex VII sets out certain specific commitments by that Party.

4. Where a Party has set out a reservation to Article 1102, 1103, 1202 or 1203 in its Schedule to Annex I, II, III or IV, the reservation shall be deemed to constitute a reservation to Article 1405 or 1406, as the case may be, to the extent that the measure, sector, subsector or activity set out in the reservation is covered by this Chapter.

Article 1410: Exceptions

1. Nothing in this Part shall be construed to prevent a Party from adopting or maintaining reasonable measures for prudential reasons, such as:

(a) the protection of investors, depositors, financial market participants, policy-holders, policy claimants, or persons to whom a fiduciary duty is owed by a financial institution or cross-border financial service provider;

(b) the maintenance of the safety, soundness, integrity or financial responsibility of financial institutions or cross-border financial service providers; and

(c) ensuring the integrity and stability of the Party's financial system.

2. Nothing in this Part applies to non-discriminatory measures of general application taken by any public entity in pursuit of monetary and related credit policies or exchange rate policies. This paragraph shall not affect a Party's obligations under Article 1106 (Investment - Performance Requirements) with respect to measures covered by Chapter Eleven (Investment) or Article 1109 (Investments - Transfers).

3. Article 1405 shall not apply to the granting by a Party to a financial institution of an exclusive right to provide a financial service referred to in Article 1401(3)(a).

4. Notwithstanding Article 1109(1), (2) and (3), as incorporated into this Chapter, and without limiting the applicability of Article 1109(4), as incorporated into this Chapter, a Party may prevent or limit transfers by a financial institution or cross-border financial services provider, through the equitable, non-discriminatory and good faith application of measures relating to maintenance of the safety, soundness, integrity or financial responsibility of financial institutions or cross-border financial service providers. This paragraph does not prejudice any other provision of this Agreement that permits a Party to restrict transfers.

Article 1411: Transparency

1. In lieu of Article 1802(2) (Publication), each Party shall, to the extent practicable, provide in advance to all interested persons any measure of general application that the Party proposes to adopt in order to allow an opportunity for such persons to comment on the measure. Such measure shall be provided:

(a) by means of official publication;

(b) in other written form; or

(c) in such other form as permits an interested person to make informed comments on the proposed measure.

2. Each Party's regulatory authorities shall make available to interested persons their requirements for completing applications relating to the provision of financial services.

3. On the request of an applicant, the regulatory authority shall inform the applicant of the status of its application. If such authority requires additional information from the applicant, it shall notify the applicant without undue delay.

4. A regulatory authority shall make an administrative decision on a completed application of an investor in a financial institution, a financial institution or a cross-border financial service provider of another Party relating to the provision of a financial service within 120 days, and shall promptly notify the applicant of the decision. An application shall not be considered complete until all relevant hearings are held and all necessary information is received. Where it is not practicable for a decision to be made within 120 days, the regulatory authority shall notify the applicant without undue delay and shall endeavor to make the decision within a reasonable time thereafter.

5. Nothing in this Chapter requires a Party to furnish or allow access to:

(a) information related to the financial affairs and accounts of individual customers of financial institutions or cross-border financial service providers; or

(b) any confidential information, the disclosure of which would impede law enforcement or otherwise be contrary to the public interest or prejudice legitimate commercial interests of particular enterprises.

6. Each Party shall maintain or establish one or more inquiry points no later than 180 days after the date of entry into force of this Agreement, to respond in writing as soon as practicable, to all reasonable inquiries from interested persons regarding measures of general application covered by this Chapter.

Article 1412: Financial Services Committee

1. The Parties hereby establish the Financial Services Committee. The principal representative of each Party shall be an official of the Party's authority responsible for financial services set out in Annex 1412.1.

2. Subject to Article 2001(2)(d)(Free Trade Commission), the Committee shall:

(a) supervise the implementation of this Chapter and its further elaboration;

(b) consider issues regarding financial services that are referred to it by a Party; and

(c) participate in the dispute settlement procedures in accordance with Article 1415.

3. The Committee shall meet annually to assess the functioning of this Agreement as it applies to financial services. The Committee shall inform the Commission of the results of each annual meeting.

Article 1413: Consultations

1. A Party may request consultations with another Party regarding any matter arising under this Agreement that affects financial services. The other Party shall give sympathetic consideration to the request. The consulting Parties shall report the results of their consultations to the Committee at its annual meeting.

2. Consultations under this Article shall include officials of the authorities specified in Annex 1412.1.

3. A Party may request that regulatory authorities of another Party participate in consultations under this Article regarding the other Party's measures of general application which may affect the operations of financial institutions or cross-border financial service providers in the requesting Party's territory.

4. Nothing in this Article shall be construed to require regulatory authorities participating in consultations under paragraph 3 to disclose information or take any action that would interfere with individual regulatory, supervisory, administrative or enforcement matters.

5. Where a Party requires information for supervisory purposes concerning a financial institution in another Party's territory or a cross-border financial services provider in another Party's territory, the Party may approach the competent regulatory authority in the other Party's territory to seek the information.

6. Annex 1413.6 shall apply to further consultations and arrangements.

Article 1414: Dispute Settlement

1. Section B of Chapter Twenty (Institutional Arrangements and Dispute Settlement Procedures) applies as modified by this Article to the settlement of disputes arising under this Chapter.

2. The Parties shall establish by January 1, 1994 and maintain a roster of up to 15 individuals who are willing and able to serve as financial services panelists. Financial services roster members shall be appointed by consensus for terms of three years, and may be reappointed.

3. Financial services roster members shall:

(a) have expertise or experience in financial services law or practice, which may include the regulation of financial institutions;

(b) be chosen strictly on the basis of objectivity, reliability and sound judgment; and

(c) meet the qualifications set out in Article 2009(2)(b) and (c) (Roster).

4. Where a Party claims that a dispute arises under this Chapter, Article 2011 (Panel Selection) shall apply, except that:

(a) where the disputing parties so agree, the panel shall be composed entirely of panelists meeting the qualifications in paragraph 3; and

(b) in any other case,

(i) each disputing Party may select panelists meeting the qualifications set out in paragraph 3 or in Article 2010(1) (Qualification of Panelists), and

(ii) if the Party complained against invokes Article 1410, the chair of the panel shall meet the qualifications set out in paragraph 3.

5. In any dispute where a panel finds a measure to be inconsistent with the obligations of this Agreement and the measure affects:

(a) only the financial services sector, the complaining Party may suspend benefits only in the financial services sector;

(b) the financial services sector and any other sector, the complaining Party may suspend benefits in the financial services sector that have an effect equivalent to the effect of the measure in the Party's financial services sector; or

(c) only a sector other than the financial services sector, the complaining Party may not suspend benefits in the financial services sector.

Article 1415: Investment Disputes in Financial Services

1. Where an investor of another Party submits a claim under Article 1116 or 1117 to arbitration under Section B of Chapter Eleven (Investment - Settlement of Disputes between a Party and an Investor of Another Party) against a Party and the disputing Party invokes Article 1410, on the request of the disputing Party, the Tribunal shall refer the matter in writing to the Committee for a decision. The Tribunal may not proceed pending receipt of a decision or report under this Article.

2. In a referral pursuant to paragraph 1, the Committee shall decide the issue of whether and to what extent Article 1410 is a valid defense to

the claim of the investor. The Committee shall transmit a copy of its decision to the Tribunal and to the Commission. The decision shall be binding on the Tribunal.

3. Where the Committee has not decided the issue within 60 days of the receipt of the referral under paragraph 1, the disputing Party or the Party of the disputing investor may request the establishment of an arbitral panel under Article 2008 (Request for an Arbitral Panel). The panel shall be constituted in accordance with Article 1414. Further to Article 2017 (Final Report), the panel shall transmit its final report to the Committee and to the Tribunal. The report shall be binding on the Tribunal.

4. Where no request for the establishment of a panel pursuant to paragraph 3 has been made within 10 days of the expiration of the 60-day period referred to in paragraph 3, the Tribunal may proceed to decide the matter.

Article 1416: Definitions

For purposes of this Chapter:

cross-border financial service provider of a Party means a person of a Party that is engaged in the business of providing a financial service within the territory of the Party and that seeks to provide or provides financial services through the cross-border provision of such services;

cross-border provision of a financial service or cross-border trade in financial services means the provision of a financial service:

(a) from the territory of a Party into the territory of another Party,

(b) in the territory of a Party by a person of that Party to a person of another Party, or

(c) by a national of a Party in the territory of another Party,

but does not include the provision of a service in the territory of a Party by an investment in that territory;

financial institution means any financial intermediary or other enterprise that is authorized to do business and regulated or supervised as a financial institution under the law of the Party in whose territory it is located;

financial institution of another Party means a financial institution, including a branch, located in the territory of a Party that is controlled by persons of another Party;

financial service means service of a financial nature, including insurance, and a service incidental or auxiliary to a service of a financial nature;

financial service provider of a Party means a person of a Party that is engaged in the business of providing a financial service within the territory of that Party;

investment means "investment" as defined in Article 1139 (Investment - Definitions), except that, with respect to "loans" and "debt securities" referred to in that Article:

(a) a loan to or debt security issued by a financial institution is an investment only where it is treated as regulatory capital by the Party in whose territory the financial institution is located; and

(b) a loan granted by or debt security owned by a financial institution, other than a loan to or debt security of a financial institution referred to in subparagraph (a), is not an investment;

for greater certainty:

(c) a loan to, or debt security issued by, a Party or a state enterprise thereof is not an investment; and

(d) a loan granted by or a debt security owned by a cross-border financial service provider, other than a loan to or debt security issued by a financial institution, is an investment if such loan or debt security meets the criteria for investments set out in Article 1139;

investor of a Party means a Party or state enterprise thereof, or a person of that Party that seeks to make, makes, or has made an investment;

new financial service means a financial service not provided in the Party's territory that is provided within the territory of another Party, and includes any new form of delivery of a financial service or the sale of a financial product that is not sold in the Party's territory;

person of a Party means "person of a Party" as defined in Chapter Two (General Definitions) and, for greater certainty, does not include a branch of an enterprise of a non-Party;

public entity means a central bank or monetary authority of a Party, or any financial institution owned or controlled by a Party; and

self-regulatory organization means any non-governmental body, including any securities or futures exchange or market, clearing agency, or other organization or association, that exercises its own or delegated regulatory or supervisory authority over financial service providers of financial institutions.

Annex 1401.4

Country-Specific Commitments

For Canada and the United States, Article 1702(1) and (2) of the Canada-United States Free Trade Agreement is hereby incorporated into and made a part of this Agreement.

Annex 1403.3

Review of Market Access

The review of market access referred to in Article 1403(3) shall not include the market access limitations specified in Section B of the Schedule of Mexico to Annex VII.

Annex 1404.4

Consultations on Liberalization of Cross-Border Trade

No later than January 1, 2000, the Parties shall consult on further liberalization of cross-border trade in financial services. In such consultations the Parties shall, with respect to insurance:

(a) consider the possibility of allowing a wider range of insurance services to be provided on a cross-border basis in or into their respective territories; and

(b) determine whether the limitations on cross-border insurance services specified in Section A of the Schedule of Mexico to Annex VII shall be maintained, modified or eliminated.

Annex 1409.1

Provincial and State Reservations

1. Canada may set out in Section A of its Schedule to Annex VII by the date of entry into force of this Agreement any existing non-conforming measure maintained at the provincial level.

2. The United States may set out in Section A of its schedule to Annex VII by the date of entry into force of this Agreement any existing non-conforming measures maintained by California, Florida, Illinois, New York, Ohio and Texas. Existing non-conforming state measures of all other states may be set out by January 1, 1995.

Annex 1412.1

Authorities Responsible for Financial Services

The authority of each Party responsible for financial services shall be:

(a) for Canada, the Department of Finance of Canada;

(b) for Mexico, the Secretaría de Hacienda y Crédito Público; and

(c) for the United States, the Department of the Treasury for banking and other financial services and the Department of Commerce for insurance services.

Annex 1413.6

Further Consultations and Arrangements

Section A - Limited Scope Financial Institutions

Three years after the date of entry into force of this Agreement, the Parties shall consult on the aggregate limit on limited scope financial institutions described in paragraph 8 of Section B of the Schedule of Mexico to Annex VII.

Section B - Payments System Protection

1. If the sum of the authorized capital of foreign commercial bank affiliates (as such term is defined in the Schedule of Mexico to Annex VII), measured as a percentage of the aggregate capital of all commercial banks in Mexico, reaches 25 percent, Mexico may request consultations with the other Parties on the potential adverse effects arising from the presence of commercial banks of the other Parties in the Mexican market and the possible need for remedial action, including further temporary limitations on market participation. The consultations shall be completed expeditiously.

2. In considering the potential adverse effects, the Parties shall take into account:

(a) the threat that the Mexican payments system may be controlled by non-Mexican persons;

(b) the effects foreign commercial banks established in Mexico may have on Mexico's ability to conduct monetary and exchange-rate policy effectively; and

(c) the adequacy of this Chapter in protecting the Mexican payments system.

3. If no consensus is reached on the matters referred to in paragraph 1 any Party may request the establishment of an arbitral panel under Article 1414 or Article 2008 (request for an Arbitral Panel). The panel proceedings shall be conducted in accordance with the Model Rules of Procedure established under Article 2012 (Rules of Procedure). The Panel shall present its determination within 60 days after the last panelist is selected or such other period as the Parties to the proceeding may agree. Article 2018 (Implementation of Final Report) and 2019 (Non-

Implementation-Suspension of Benefits) shall not apply in such proceedings.

* * * * *

Chapter Twenty

Institutional Arrangements and Dispute Settlement Procedures

Section A - Institutions

Article 2001: The Free Trade Commission

1. The Parties hereby establish the Free Trade Commission, comprising cabinet-level representatives of the Parties or their designees.

2. The Commission shall:

   (a) supervise the implementation of this Agreement;

   (b) oversee its further elaboration;

   (c) resolve disputes that may arise regarding its interpretation or application;

   (d) supervise the work of all committees and working groups established under this Agreement, referred to in Annex 2001.2; and

   (e) consider any other matter that may affect the operation of this Agreement.

3. The Commission may:

   (a) establish, and delegate responsibilities to, ad hoc or standing committees, working groups or expert groups;

   (b) seek the advice of non-governmental persons or groups; and

   (c) take such other action in the exercise of its functions as the Parties may agree.

4. The Commission shall establish its rules and procedures. All decisions of the Commission shall be taken by consensus, except as the Commission may otherwise agree.

5. The Commission shall convene at least once a year in regular session. Regular sessions of the Commission shall be chaired successively by each Party.

Article 2002: The Secretariat

1. The Commission shall establish and oversee a Secretariat comprising national Sections.

2. Each Party shall:

   (a) establish a permanent office of its Section;

   (b) be responsible for

      (i) the operation and costs of its Section, and

      (ii) the remuneration and payment of expenses of panelists and members of committees and scientific review boards established under this Agreement, as set out in Annex 2002.2;

   (c) designate an individual to serve as Secretary for its Section, who shall be responsible for its administration and management; and

   (d) notify the Commission of the location of its Section's office.

3. The Secretariat shall:

   (a) provide assistance to the Commission;

   (b) provide administrative assistance to

      (i) panels and committees established under Chapter Nineteen (Review and Dispute Settlement in Antidumping and Countervailing Duty Matters), in accordance with the procedures established pursuant to Article 1908, and

      (ii) panels established under this Chapter, in accordance with procedures established pursuant to Article 2012; and

   (c) as the Commission may direct

      (i) support the work of other committees and groups established under this Agreement, and

      (ii) otherwise facilitate the operation of this Agreement.

Section B - Dispute Settlement

Article 2003: Cooperation

The Parties shall at all times endeavor to agree on the interpretation and application of this Agreement, and shall make every attempt through cooperation and consultations to arrive at a mutually satisfactory resolution of any matter that might affect its operation.

Article 2004: Recourse to Dispute Settlement Procedures

Except for the matters covered in Chapter Nineteen (Review and Dispute Settlement in Antidumping and Countervailing Duty Matters) and as otherwise provided in this Agreement, the dispute settlement provisions of this Chapter shall apply with respect to the avoidance or settle-

ment of all disputes between the Parties regarding the interpretation or application of this Agreement or wherever a Party considers that an actual or proposed measure of another Party is or would be inconsistent with the obligations of this Agreement or cause nullification or impairment in the sense of Annex 2004.

Article 2005: GATT Dispute Settlement

1. Subject to paragraphs 2, 3 and 4, disputes regarding any matter arising under both this Agreement and the *General Agreement on Tariffs and Trade*, any agreement negotiated thereunder, or any successor agreement (GATT), may be settled in either forum at the discretion of the complaining Party.

2. Before a Party initiates a dispute settlement proceeding in the GATT against another Party on grounds that are substantially equivalent to those available to the Party under this Agreement, that Party shall notify any third Party of its intention. If a third Party wishes to have recourse to dispute settlement procedures under this Agreement regarding the matter, it shall inform promptly the notifying Party and those Parties shall consult with a view to agreement on a single forum. If those Parties cannot agree, the dispute normally shall be settled under this Agreement.

3. In any dispute referred to in paragraph 1 where the responding Party claims that its action is subject to Article 104 (Relation to Environment and Conservation Agreement) and requests in writing that the matter be considered under this Agreement, the complaining Party may, in respect of that matter, thereafter have recourse to dispute settlement procedures solely under this Agreement.

4. In any dispute referred to in paragraph 1 that arises under Section B of Chapter Seven (Sanitary and Phytosanitary Measures) or Chapter Nine (Standards-Related Measures):

(a) concerning a measure adopted or maintained by a Party to protect its human, animal, or plant life or health, or to protect its environment, and

(b) that raises factual issues concerning the environment, health, safety or conservation, including directly related scientific matters,

where the responding Party requests in writing that the matter be considered under this Agreement, the complaining Party may, in respect of that matter, thereafter have recourse to dispute settlement procedures solely under this Agreement.

5. The responding Party shall deliver a copy of a request made pursuant to paragraph 3 or 4 to the other Parties and to its Section of the Secretariat. Where the complaining Party has initiated dispute settlement proceedings regarding any matter subject to paragraph 3 or 4, the responding Party shall deliver its request no later than 15 days thereafter. On receipt of such request, the complaining Party shall promptly withdraw from participation in those proceedings and may initiate dispute settlement procedures under Article 2007.

6. Once dispute settlement procedures have been initiated under Article 2007 or dispute settlement proceedings have been initiated under the GATT, the forum selected shall be used to the exclusion of the other, unless a Party makes a request pursuant to paragraph 3 or 4.

7. For purposes of this Article, dispute settlement proceedings under the GATT are deemed to be initiated by a Party's request for a panel, such as under Article XXIII: 2 of the *General Agreement on Tariffs and Trade 1947*, or for a committee investigation, such as under Article 20.1 of the Customs Valuation Code.

Consultations

Article 2006: Consultations

1. Any Party may request in writing consultations with any other Party regarding any actual or proposed measure or any other matter that it considers might affect the operation of this Agreement.

2. The requesting Party shall deliver the request to the other Parties and to its Section of the Secretariat.

3. Unless the Commission otherwise provides in its rules and procedures established under Article 2001(4), a third Party that considers it has a substantial interest in the matter shall be entitled to participate in the consultations on delivery of written notice to the other Parties and to its Section of the Secretariat.

4. Consultations on matters regarding perishable agricultural goods shall commence within 15 days of the date of delivery of the request.

5. The consulting Parties shall make every attempt to arrive at a mutually satisfactory resolution of any matter through consultations under this Article or other consultative provisions of this Agreement. To this end, the consulting Parties shall:

(a) provide sufficient information to enable a full examination of how the actual or proposed measure or other matter might affect the operation of this Agreement;

(b) treat any confidential or proprietary information exchanged in the course of consultations on the same basis as the Party providing the information; and

(c) seek to avoid any resolution that adversely affects the interests under this Agreement of any other Party.

Initiation of Procedures

Article 2007: Commission-Good Offices, Conciliation and Mediation

1. If the consulting Parties fail to resolve a matter pursuant to Article 2006 within:

(a) 30 days of delivery of a request for consultations,

(b) 45 days of delivery of such request if any other Party has subsequently requested or has participated in consultations regarding the same matter,

(c) 15 days of delivery of a request for consultations in matters regarding perishable agricultural goods, or

(d) such other period as they may agree,

any such Party may request in writing a meeting of the Commission.

2. A Party may also request in writing a meeting of the Commission where:

(a) it has initiated dispute settlement proceedings under the GATT regarding any matter subject to Article 2005(3) or (4), and has received a request pursuant to Article 2005(5) for recourse to dispute settlement procedures under this Chapter; or

(b) consultations have been held pursuant to Article 513 (Working Group on Rules of Origin), Article 723 (Sanitary and Phytosanitary Measures - Technical Consultations) and Article 914 (Standards-Related Measures - Technical Consultations).

3. The requesting Party shall state in the request the measure or other matter complained of and indicate the provisions of this Agreement that it considers relevant, and shall deliver the request to the Parties and to its Section of the Secretariat.

4. Unless it decides otherwise, the Commission shall convene within 10 days of delivery of the request and shall endeavor to resolve the dispute promptly.

5. The Commission may:

(a) call on such technical advisers or create such working groups or expert groups as it deems necessary,

(b) have recourse to good offices, conciliation, mediation or such other dispute resolution procedures, or

(c) make recommendations,

as may assist the consulting Parties to reach a mutually satisfactory resolution of the dispute.

6. Unless it decides otherwise, the Commission shall consolidate two or more proceedings before it pursuant to this Article regarding the same measure. The Commission may consolidate two or more proceedings regarding other matters before it pursuant to this Article that it determines are appropriate to be considered jointly.

Panel Proceedings

Article 2008: Request for an Arbitral Panel

1. If the Commission has convened pursuant to Article 2007(4), and the matter has not been resolved within:

(a) 30 days thereafter,

(b) 30 days after the Commission has convened in respect of the matter most recently referred to it, where proceedings have been consolidated pursuant to Article 2007(6), or

(c) such other period as the consulting Parties may agree,

any consulting Party may request in writing the establishment of an arbitral panel. The requesting Party shall deliver the request to the other Parties and to its Section of the Secretariat.

2. On delivery of the request, the Commission shall establish an arbitral panel.

3. A third Party that considers it has a substantial interests in the matter shall be entitled to join as a complaining Party on delivery of written notice of its intention to participate to the disputing Parties and its Section of the Secretariat. The notice shall be delivered at the earliest possible time, and in any event no later than seven days after the date of delivery of a request by a Party for the establishment of a panel.

4. If a third Party does not join as a complaining Party in accordance with paragraph 3, it normally shall refrain thereafter from initiating or continuing:

(a) a dispute settlement procedure under this Agreement, or

(b) a dispute settlement proceeding in the GATT on grounds that are substantially equivalent to those available to that Party under this Agreement,

regarding the same matter in the absence of a significant change in economic or commercial circumstances.

5. Unless otherwise agreed by the disputing Parties, the panel shall be established and perform its functions in a manner consistent with the provisions of this Chapter.

Article 2009: Roster

1. The Parties shall establish by January 1, 1994 and maintain a roster of up to 30 individuals who are willing and able to serve as panelists. The roster members shall be appointed by consensus for terms of three years, and may be reappointed.

2. Roster members shall:

(a) have expertise or experience in law, international trade, other matters covered by this Agreement or the resolution of disputes arising under international trade agreements, and shall be chosen strictly on the basis of objectivity, reliability and sound judgment.

(b) be independent of, and not be affiliated with, or take instructions from, any Party; and

(c) comply with a code of conduct to be established by the Commission.

Article 2010: Qualifications of Panelists

1. All panelists shall meet the qualifications set out in Article 2009(2).

2. Individuals may not serve as panelists for a dispute in which they have participated pursuant to Article 2007(5).

Article 2011: Panel Selection

1. Where there are two disputing Parties, the following procedures shall apply:

(a) The panel shall comprise five members.

(b) The disputing Parties shall endeavor to agree on the chair of the panel within 15 days of the delivery of the request for the establishment of the panel. If the disputing Parties are unable to agree on the chair within this period, the disputing Party cho-

sen by lot shall select within five days as chair an individual who is not a citizen of that Party.

(c) Within 15 days of selection of the chair, each disputing Party shall select two panelists who are citizens of the other disputing Party.

(d) If a disputing Party fails to select its panelists within such period, such panelists shall be selected by lot from among the roster members who are citizens of the other disputing Party.

2. Where there are more than two disputing Parties, the following procedures shall apply:

(a) The panel shall comprise five members.

(b) The disputing Parties shall endeavor to agree on the chair of the panel within 15 days of the delivery of the request for the establishment of the panel. If the disputing Parties are unable to agree on the chair within this period, the Party or Parties on the side of the dispute chosen by lot shall select within 10 days a chair who is not a citizen of such Party or Parties.

(c) Within 15 days of selection of the chair, the Party complained against shall select two panelists, one of whom is a citizen of a complaining Party, and the other of whom is a citizen of another complaining Party. The complaining Parties shall select two panelists who are citizens of the Party complained against.

(d) If any disputing Party fails to select a panelist within such period, such panelist shall be selected by lot in accordance with the citizenship criteria of subparagraph (c).

3. Panelists shall normally be selected from the roster. Any disputing Party may exercise a peremptory challenge against any individual not on the roster who is proposed as a panelist by a disputing Party within 15 days after the individual has been proposed.

4. If a disputing Party believes that a panelist is in violation of the code of conduct, the disputing Parties shall consult and if they agree, the panelist shall be removed and a new panelist shall be selected in accordance with this Article.

Article 2012: Rules of Procedure

1. The Commission shall establish by January 1, 1994 Model Rules of Procedure, in accordance with the following principles:

(a) the procedures shall assure a right to at least one hearing before the panel as well as the opportunity to provide initial and rebuttal written submissions; and

(b) the panel's hearings, deliberations and initial report, and all written submissions to and communications with the panel shall be confidential.

2. Unless the disputing Parties otherwise agree, the panel shall conduct its proceedings in accordance with the Model Rules of Procedure.

3. Unless the disputing Parties otherwise agree within 20 days from the date of the delivery of the request for the establishment of the panel, the terms of reference shall be:

"to examine, in the light of the relevant provisions of the Agreement, the matter referred to the Commission (as set out in the request for a Commission meeting) and to make findings, determinations and recommendations as provided in Article 2016(2)."

4. If a complaining Party wishes to argue that a matter has nullified or impaired benefits, the terms of reference shall so indicate.

5. If a disputing Party wishes the panel to make findings as to the degree of adverse trade effects on any Party of any measure found not to conform with the obligations of the Agreement or to have caused nullification or impairment in the sense of Annex 2004, the terms of reference shall so indicate.

Article 2013: Third Party Participation

A Party that is not a disputing Party, on delivery of a written notice to the disputing Parties and to its Section of the Secretariat, shall be entitled to attend all hearings, to make written and oral submissions to the panel and to receive written submissions of the disputing Parties.

Article 2014: Role of Experts

On request of a disputing Party, or on its own initiative, the panel may seek information and technical advice from any person or body that it deems appropriate, provided that the disputing Parties so agree and subject to such terms and conditions as such Parties may agree.

Article 2015: Scientific Review Boards

1. On request of a disputing Party or, unless the disputing parties disapprove, on its own initiative, the panel may request a written report of a scientific review board on any factual issue concerning environmental, health, safety or other scientific matters raised by a disputing Party in a

proceeding, subject to such terms and conditions as such Parties may agree.

2. The board shall be selected by the panel from among highly qualified, independent experts in the scientific matters, after consultations with the disputing Parties and the scientific bodies set out in the Model Rules of Procedure established pursuant to Article 2012(1).

3. The participating Parties shall be provided:

(a) advance notice of, and an opportunity to provide comments to the panel on, the proposed factual issues to be referred to the board; and

(b) a copy of the board's report and an opportunity to provide comments on the report to the panel.

4. The panel shall take the board's report and any comments by the Parties on the report into account in the preparation of its report.

Article 2016: Initial Report

1. Unless the disputing Parties otherwise agree, the panel shall base its report on the submissions and arguments of the Parties and on any information before it pursuant to Article 2014 or 2015.

2. Unless the disputing Parties otherwise agree, the panel shall, within 90 days after the last panelist is selected or such other period as the Model Rules of Procedure established pursuant to Article 2012(1) may provide, present to the disputing Parties an initial report containing:

(a) findings of fact, including any findings pursuant to a request under Article 2012(5);

(b) its determination as to whether the measure at issue is or would be inconsistent with the obligations of this Agreement or cause nullification or impairment in the sense of Annex 2004, or any other determination requested in the terms of reference; and

(c) its recommendations, if any, for resolution of the dispute.

3. Panelists may furnish separate opinions on matters not unanimously agreed.

4. A disputing Party may submit written comments to the panel on its initial report within 14 days of presentation of the report.

5. In such an event, and after considering such written comments, the panel, on its own initiative or on the request of any disputing Party, may:

(a) request the views of any participating Party;

(b) reconsider its report; and

(c) make any further examination that it considers appropriate.

Article 2017: Final Report

1. The panel shall present to the disputing Parties a final report, including any separate opinions on matters not unanimously agreed, within 30 days of presentation of the initial report, unless the disputing Parties otherwise agree.

2. No panel may, either in its initial report or its final report, disclose which panelists are associated with majority or minority opinions.

3. The disputing Parties shall transmit to the Commission the final report of the panel, including any report of a scientific review board established under Article 2015, as well as any written views that a disputing Party desires to be appended, on a confidential basis within a reasonable period of time after it is presented to them.

4. Unless the Commission decides otherwise, the final report of the panel shall be published 15 days after it is transmitted to the Commission.

Implementation of Panel Reports

Article 2018: Implementation of Final Report

1. On receipt of the final report of a panel, the disputing Parties shall agree on the resolution of the dispute, which normally shall conform with the determinations and recommendations of the panel, and shall notify their Sections of the Secretariat of any agreed resolution of any dispute.

2. Wherever possible, the resolution shall be non-implementation or removal of a measure not conforming with this Agreement or causing nullification or impairment in the sense of Annex 2004 or, failing such a resolution, compensation.

Article 2019: Non-Implementation - Suspension of Benefits

1. If in its final report a panel has determined that a measure is inconsistent with the obligations of this Agreement or causes nullification or impairment in the sense of Annex 2004 and the Party complained against has not reached agreement with any complaining Party on a mutually satisfactory resolution pursuant to Article 2018(1) within 30 days of receiving the final report, such complaining Party may suspend the application to the Party complained against of benefits of equivalent effect until such time as they have reached agreement on a resolution of the dispute.

2. In considering what benefits to suspend pursuant to paragraph 1:

(a) a complaining Party should first seek to suspend benefits in the same sector or sectors as that affected by the measure or other matter that the panel has found to be inconsistent with the obligations of this Agreement or to have caused nullification or impairment in the sense of Annex 2004; and

(b) a complaining Party that considers it is not practicable or effective to suspend benefits in the same sector or sectors may suspend benefits in other sectors.

3. On the written request of any disputing Party delivered to the other Parties and its Section of the Secretariat, the Commission shall establish a panel to determine whether the level of benefits suspended by a Party pursuant to paragraph 1 is manifestly excessive.

4. The panel proceedings shall be conducted in accordance with the Model Rules of Procedure. The panel shall present its determination within 60 days after the last panelist is selected or such other period as the disputing Parties may agree.

Section C - Domestic Proceedings and Private Commercial Dispute Settlement

Article 2020: Referrals of Matters from Judicial or Administrative Proceedings

1. If an issue of interpretation or application of this Agreement arises in any domestic judicial or administrative proceeding of a Party that any Party considers would merit its intervention, or if a court or administrative body solicits the views of a Party, that Party shall notify the other Parties and its Section of the Secretariat. The Commission shall endeavor to agree on an appropriate response as expeditiously as possible.

2. The Party in whose territory the court or administrative body is located shall submit any agreed interpretation of the Commission to the court or administrative body in accordance with the rules of that forum.

3. If the Commission is unable to agree, any Party may submit its own views to the court or administrative body in accordance with the rules of that forum.

* * * * *

Article 2022: Alternative Dispute Resolution

1. Each Party shall, to the maximum extent possible, encourage and facilitate the use of arbitration and other means of alternative dispute resolution for the settlement of international commercial disputes between private parties in the free trade area.

2. To this end, each Party shall provide appropriate procedures to ensure observance of agreements to arbitrate and for the recognition and enforcement of arbitral awards in such disputes.

3. A Party shall be deemed to be in compliance with paragraph 2 if it is a party to and is in compliance with the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards or the 1975 Inter-American Convention on International Commercial Arbitration.

4. The Commission shall establish an Advisory Committee on Private Commercial Disputes comprising persons with expertise or experience in the resolution of private international commercial disputes. The Committee shall report and provide recommendations to the Commission on general issues referred to it by the Commission respecting the availability, use and effectiveness of arbitration and other procedures for the resolution of such disputes in the free trade area.

Annex 2001.2

Committees and Working Groups

A. Committees:

1. Committee on Trade in Goods (Article 316)
2. Committee on Trade in Worn Clothing (Annex 300-B, Section 9.1)
3. Committee on Agricultural Goods (Article 706)
   - Advisory Committee on Private Commercial Disputes Regarding Agricultural Goods (Article 707)
4. Committee on Sanitary and Phytosanitary Measures (Article 722)
5. Committee on Standards-Related Measures (Article 913)
   - Land Transportation Standards Subcommittee (Article 913(5))
   - Telecommunications Standards Subcommittee (Article 913(5))
   - Automotive Standards Council (Article 913(5))
   - Subcommittee on Labelling of Textile and Apparel Goods (Article 913(5))
6. Committee on Small Business (Article 1021)
7. Financial Services Committee (Article 1412)
8. Advisory Committee on Private Commercial Disputes (Article 2022(4))

B. Working Groups:

1. Working Group on Rules of Origin (Article 513)
   - Customs Subgroup (Article 513(6))

2. Working Group on Agricultural Subsidies (Article 705(6))
3. Bilateral Working Group (Mexico - United States) (Annex 703.2 (A)(25))
4. Bilateral Working Group (Canada - Mexico) (Annex 703.2(B)(13))
5. Working Group on Trade and Competition (Article 1504)
6. Temporary Entry Working Group (Article 1605)

C. Other Committees and Working Groups Established Under This Agreement

Annex 2002.2

Remuneration and Payment of Expenses

1. The Commission shall establish the amounts of remuneration and expenses that will be paid to the panelists, committee members and members of scientific review boards.

2. The remuneration of panelists or committee members and their assistants, members of scientific review boards, their travel and lodging expenses, and all general expenses of panels, committees or scientific review boards shall be borne equally by:

(a) in the case of panels or committees established under Chapter Nineteen (Review and Dispute Settlement in Antidumping and Countervailing Duty Matters), the involved Parties, as they are defined in Article 1911; or

(b) in the case of panels and scientific review boards established under this Chapter, the disputing Parties.

3. Each panelist or committee member shall keep a record and render a final account of the person's time and expenses, and the panel, committee or scientific review board shall keep a record and render a final account of all general expenses. The Commission shall establish amounts of remuneration and expenses that will be paid to panelists and committee members.

Annex 2004

Nullification and Impairment

1. If any Party considers that any benefit it could reasonably have expected to accrue to it under any provision of:

(a) Part Two (Trade in Goods), except for those provisions of Annex 300-A (Automotive Sector) or Chapter Six (Energy) relating to investment,

(b) Part Three (Technical Barriers to Trade),

(c) Chapter Twelve (Cross-Border Trade in Services), or

(d) Part Six (Intellectual Property),

is being nullified or impaired as a result of the application of any measure that is not inconsistent with this Agreement, the Party may have recourse to dispute settlement under this Chapter.

2. A Party may not invoke:

(a) paragraph 2(a) or (b), to the extent that the benefit arises from any cross-border trade in services provision of Part Two, or

(b) paragraph 1(c) or (d)

with respect to any measure subject to an exception under Article 2101 (General Exceptions).

Chapter Twenty-One

Exceptions

* * * * *

Article 2104: Balance of Payments

1. Nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining measures that restrict transfers where the Party experiences serious balance of payments difficulties, or the threat thereof, and such restrictions are consistent with paragraphs 2 through 4 and are:

(a) consistent with paragraph 5 to the extent they are imposed on other transfers than cross-border trade in financial services; or

(b) consistent with paragraphs 6 and 7 to the extent they are imposed on cross-border trade in financial services.

General Rules

2. As soon as practicable after a party imposes a measure under this Article, the Party shall:

(a) submit any current account exchange restrictions to the IMF for review under Article VIII of the Article of Agreement of the IMF;

(b) enter into good faith consultations with the IMF on economic adjustment measures to address the fundamental underlying economic problems causing the difficulties; and

(c) adopt or maintain economic policies consistent with such consultations.

3. A measure adopted or maintained under this Article shall:

(a) avoid unnecessary damage to the commercial, economic or financial interests of another Party;

(b) not be more burdensome than necessary to deal with the balance of payments difficulties or threat thereof;

(c) be temporary and be phased out progressively as the balance of payments situation improves;

(d) be consistent with paragraph 2(c) and with the Articles of Agreement of the IMF; and

(e) be applied on a national treatment or most-favored-nation treatment basis, whichever is better.

4. A Party may adopt or maintain a measure under this Article that gives priority to services that are essential to its economic program, provided that a Party may not impose a measure for the purpose of protecting a specific industry or sector unless the measure is consistent with paragraph 2(c) and with Article VIII(3) of the Articles of Agreement of the IMF.

Restrictions on Transfers Other than Cross-Border Trade in Financial Services

5. Restrictions imposed on transfers, other than on cross-border trade in financial services:

(a) where imposed on payments for current international transactions, shall be consistent with Article VIII(3) of the Articles of Agreement of the IMF;

(b) where imposed on international capital transactions, shall be consistent with Article VI of the Articles of Agreement of the IMF and be imposed only in conjunction with measures imposed on current international transactions under paragraph 2(a);

(c) where imposed on transfers covered by Article 1109 (Investment-Transfers) and transfers related to trade in goods, may not substantially impede transfers from being made in a freely usable currency at a market rate of exchange; and

(d) may not take the form of tariff surcharges, quotas, licenses or similar measures.

Restrictions on Cross-Border Trade in Financial Services

6. A Party imposing a restriction on cross-border trade in financial services:

(a) may not impose more than one measure on any transfer, unless consistent with paragraph 2(c) and with Article VIII(3) of the Articles of Agreement of the IMF; and

(b) shall promptly notify and consult with the other parties to assess the balance of payments situation of the Party and the measures it has adopted, taking into account among other elements

(i) the nature and extent of the balance of payments difficulties of the Party,

(ii) the external economic and trading environment of the Party, and

(iii) alternative corrective measures that may be available.

7. In consultations under paragraph 6(b), the Parties shall:

(a) consider if measures adopted under this Article comply with paragraph 3, in particular paragraph 3(c); and

(b) accept all findings of statistical and other facts presented by the IMF relating to foreign exchange, monetary reserves and balance of payments, and shall base their conclusions on the assessment by the IMF of the balance of payments situation of the Party adopting the measures.

* * * * *

Article 2107: Definitions

For purposes of this Chapter:

* * * * *

international capital transactions means "international capital transactions" as defined under the Articles of Agreement of the IMF;

IMF means the International Monetary Fund;

payments for current international transactions means "payments for current international transactions" as defined under the Articles of Agreement of the IMF;

tax convention means a convention for the avoidance of double taxation or other international taxation agreement or arrangement;

taxes and **taxation measures** do not include:

(a) a "customs duty" as defined in Article 318 (Market Access - Definitions); or

(b) the measures listed in exceptions (b), (c), (d) and (e) of that definition; and

transfers means international transactions and related international transfers and payments.

* * * * *

Appendix II
International Financial Materials

Appendix II

1 International Foreign Exchange Master Agreement (IFEMA)

INTERNATIONAL FOREIGN EXCHANGE MASTER AGREEMENT[1]

MASTER AGREEMENT dated as of ______ , 19___ , by and between _______________ , a _____ , and _______ , a _______ .

SECTION 1. DEFINITIONS

Unless otherwise required by the context, the following terms shall have the following meanings in the Agreement:

"Agreement" has the meaning given to it in Section 2.2.

"Base Currency" means as to a Party the Currency agreed as such in relation to it in Part VIII of the Schedule hereto.

"Base Currency Rate" means as to a Party and any amount the cost (expressed as a percentage rate per annum) at which that Party would be able to fund that amount from such sources and for such periods as it may in its reasonable discretion from time to time decide, as determined in good faith by it.

"Business Day" means (i) a day which is a Local Banking Day for the applicable Designated Office of both Parties, or (ii) solely in relation to delivery of a Currency, a day which is a Local Banking Day in relation to that Currency.

"Close-Out Amount" has the meaning given to it in Section 5.1.

"Close-Out Date" means a day on which, pursuant to the provisions of Section 5.1, the Non-Defaulting Party closes out and liquidates Currency Obligations or such a close-out and liquidation occurs automatically.

"Closing Gain" means, as to the Non-Defaulting Party, the difference described as such in relation to a particular Value Date under the provisions of Section 5.1.

[1] This text is reproduced with permission from the Foreign Exchange Committee. It was prepared by the Foreign Exchange Committee in association with the British Bankers' Association and is dated November 1993.

"Closing Loss" means, as to the Non-Defaulting Party, the difference described as such in relation to a particular Value Date under the provisions of Section 5.1.

"Confirmation" means a writing (including telex, facsimile or other electronic means from which it is possible to produce a hard copy) evidencing an FX Transaction governed by the Agreement which shall specify (i) the Parties thereto and their Designated Offices through which they are respectively acting, (ii) the amounts of the Currencies being bought or sold and by which Party, (iii) the Value Date, and (iv) any other term generally included in such a writing in accordance with the practice of the relevant foreign exchange market.

"Credit Support Document" means, as to a Party (the "first Party"), a guaranty, hypothecation agreement, margin of security agreement or document, or any other document containing an obligation of a third party ("Credit Support Provider") or of the first Party in favor of the other Party supporting any obligations of the first Party hereunder.

"Credit Support Provider" has the meaning given to it in the definition of Credit Support Document.

"Currency" means money denominated in the lawful currency of any country or the Ecu.

"Currency Obligation" means any obligation of a Party to deliver a Currency pursuant to an FX Transaction governed by the Agreement, or pursuant to the application of Sections 3.3(a) or 3.3(b).

"Custodian" has the meaning given to it in the definition of Event of Default.

"Defaulting Party" has the meaning given to it in the definition of Event of Default.

"Designated Office(s)" means, as to a Party, the office(s) specified in Part II of the Schedule hereto, as such Schedule may be modified from time to time by agreement of the Parties.

"Effective Date" means the date of this Master Agreement.

"Event of Default" means the occurrence of any of the following with respect to a Party (the "Defaulting Party," the other Party being the "Non-Defaulting Party"):

(i) the Defaulting Party shall default in any payment under the Agreement to the Non-Defaulting Party with respect to any sum when due under any Currency Obligation or pursuant to the Agreement and such failure shall continue for two (2) Business Days after written notice

of non-payment given by the Non-Defaulting Party to the Defaulting Party;

(ii) the Defaulting Party shall commence a voluntary case or other proceeding seeking liquidation, reorganization or other similar relief with respect to itself or to its debts under any bankruptcy, insolvency or similar law, or seeking the appointment of a trustee, receiver, liquidator, conservator, administrator, custodian or other similar official (each, a "Custodian") of it or any substantial part or its assets; or shall take any corporate action to authorize any of the foregoing;

(iii) an involuntary case of other proceeding shall be commenced against the Defaulting Party seeking liquidation, reorganization or other similar relief with respect to it or its debts under any bankruptcy, insolvency or similar law or seeking the appointment of a Custodian of it or any substantial part of its assets, and such involuntary case or other proceeding is not dismissed within five (5) days of its institution or presentation;

(iv) the Defaulting Party is bankrupt or insolvent, as defined under any bankruptcy or insolvency law applicable to such Party;

(v) the Defaulting Party shall otherwise be unable to pay its debts as they become due;

(vi) the Defaulting Party or any Custodian acting on behalf of the Defaulting Party shall disaffirm, disclaim or repudiate any Currency Obligation;

(vii) (a) any representation or warranty made or deemed made by the Defaulting Party pursuant to the Agreement or pursuant to any Credit Support Document shall prove to have been false or misleading in any material respect as at the time it was made or given and one (1) Business Day has elapsed after the Non-Defaulting Party has given the Defaulting Party written notice thereof, or (b) the Defaulting Party fails to perform or comply with any obligation assumed by it under the Agreement (other than an obligation to make payment of the kind referred to in Clause (i) of this definition of Event of Default), and such failure is continuing thirty (30) days after the Non-Defaulting Party has given the Defaulting Party written notice thereof;

(viii) the Defaulting Party consolidates or amalgamates with or merges into or transfers all or substantially all its assets to another entity and (a) the creditworthiness of the resulting, surviving or transferee entity is materially weaker than that of the Defaulting Party prior to such action, or (b) at the time of such consolidation, amalgamation, merger or transfer the resulting, surviving or transferee entity fails to assume all the obli-

gations of the Defaulting Party under the Agreement by operation of Law or pursuant to an agreement satisfactory to the Non-Defaulting Party;

(ix) by reason of any default, or event of default or other similar condition or event, any Specified Indebtedness (being Specified Indebtedness of an amount which, when expressed in the Currency of the Threshold Amount, is in aggregate equal to or in excess of the Threshold Amount) of the Defaulting Party or any Credit Support Provider in relation to it: (a) is not paid on the due date therefor and remains unpaid after any applicable grace period has elapsed, or (b) becomes, or becomes capable at any time of being declared, due and payable under agreements or instruments evidencing such Specified Indebtedness before it would otherwise have been due and payable.

(x) the Defaulting Party is in breach of or default under any Specified Transaction and any applicable grace period has elapsed, and there occurs any liquidation or early termination of, or acceleration of obligations under that Specified Transaction of the Defaulting Party (or any Custodian on its behalf) disaffirms, disclaims or repudiates the whole or any part of a Specified Transaction; or

(xi) (a) any Credit Support Provider in relation to the Defaulting Party or the Defaulting Party itself fails to comply with or perform any agreement or obligation to be complied with or performed by it in accordance with the applicable Credit Support Document and such failure is continuing after any applicable grace period has elapsed; (b) any Credit Support Document relating to the Defaulting Party expires or ceases to be in full force and effect prior to the satisfaction of all obligations of the Defaulting Party under the Agreement, unless otherwise agreed in writing by the Non-Defaulting Party; (c) the Defaulting Party or its Credit Support Provider (or, in either case, any Custodian acting on its behalf) disaffirms, disclaims or repudiates, in whole or in part, or challenges the validity of, the Credit Support Document; (d) any representation or warranty made or deemed made by any Credit Support Provider pursuant to any Credit Support Document shall prove to have been false or misleading in any material respect as at the time it was made or given or deemed made or given and one (1) Business Day has elapsed after the Non-Defaulting Party has given the Defaulting Party written notice thereof; or (e) any event set out in (ii) to (vi) or (viii) to (x) above occurs in respect of the Credit Support Provider.

"FX Transaction" means any transaction between the Parties for the purchase by one Party of an agreed amount in one Currency against the sale by it to the other of an agreed amount in another Currency both such amounts being deliverable on the same Value Date, and in respect

of which transaction the Parties have agreed (whether orally, electronically or in writing): the Currencies involved, the amounts of such Currencies to be purchased and sold, which Party will purchase which Currency and the Value Date.

"Local Banking Day" means (i) for any Currency, a day on which commercial banks effect deliveries of that Currency in accordance with the market practice of the relevant foreign exchange market, and (ii) for any Party, a day in the location of the applicable Designated Office of such Party on which commercial banks in that location are not authorized or required by law to close.

"Master Agreement" means the terms and conditions set forth in this master agreement.

"Matched Pair Novation Netting Office(s)" means in respect of a Party the Designated Office(s) specified in Part V of the Schedule, as such Schedule may be modified from time to time by agreement of the Parties.

"Non-Defaulting Party" has the meaning given to it in the definition of Event of Default.

"Novation Netting Office(s)" means in respect of a Party the Designated Office(s) specified in Part IV of the Schedule, as such Schedule may be modified from time to time by agreement of the Parties.

"Parties" means the parties to the Agreement and shall include their successors and permitted assigns (but without prejudice to the application of Clause (viii) of the definition of Event of Default); and the term "Party" shall mean whichever of the Parties is appropriate in the context in which such expression may be used.

"Proceedings" means any suit, action or other proceedings relating to the Agreement.

"Settlement Netting Office(s)" means, in respect of a Party, the Designated Office(s) specified in Part III of the Schedule, as such Schedule may be modified from time to time by agreement of the Parties.

"Specified Indebtedness" means any obligation (whether present or future, contingent or otherwise, as principal or surety or otherwise) in respect of borrowed money, other than in respect of deposits received.

"Specified Transaction" means any transaction (including an agreement with respect thereto) between one Party to the Agreement (or any Credit Support Provider of such Party) and the other Party to the Agreement (or any Credit Support Provider of such Party) which is a rate swap transaction, basis swap, forward rate transaction, commodity sweep, commodity option, equity or equity linked swap, equity or equity index

option, bond option, interest rate option, foreign exchange transaction, cap transaction, floor transaction, collar transaction, currency swap transaction, cross-currency rate swap transaction, currency option or any other similar transaction (including any option with respect to any of these transactions) or any combination of any of the foregoing transactions.

"Split Settlement" has the meaning given to it in the definition of Value Date.

"Threshold Amount" means the amount specified as such for each Party in Part IX of the Schedule.

"Value Date" means, with respect to any FX Transaction, the Business Day (or where market practice in the relevant foreign exchange market in relation to the two Currencies involved provides for delivery of one Currency on one date which is a Local Banking Day in relation to that Currency but not to the other Currency and for delivery of the other Currency on the next Local Banking Day in relation to that other Currency ("Split Settlement") the two Local Banking Days in accordance with that market practice) agreed by the Parties for delivery of the Currencies to be purchased and sold pursuant to such FX Transaction, and, with respect to any Currency Obligation, the Business Day (or, in the case of Split Settlement, Local Banking Day) upon which the obligation to deliver Currency pursuant to such Currency Obligation is to be performed.

SECTION 2. FX TRANSACTIONS

2.1. Scope of the Agreement. (a) Unless otherwise agreed in writing by the Parties, each FX Transaction entered into between two Designated Offices of the Parties on or after the Effective Date shall be governed by the Agreement. (b) All FX Transactions between any two Designated Offices of the Parties outstanding on the Effective Date which are identified in Part I of the Schedule shall be FX Transactions governed by the Agreement and every obligation of the Parties thereunder to deliver a Currency shall be a Currency Obligation under the Agreement.

2.2. Single Agreement. This Master Agreement, the particular terms agreed between the Parties in relation to each and every FX Transaction governed by this Master Agreement (and, insofar as such terms are recorded in a Confirmation, each such Confirmation), the Schedule to this Master Agreement and all amendments to any of such items shall together form the agreement between the Parties (the "Agreement") and shall together constitute a single agreement between the Parties. The Parties acknowledge that all FX Transactions governed by the Agreement

are entered into in reliance upon the fact that all items constitute a single agreement between the Parties.

2.3. Confirmations. FX Transactions governed by the Agreement shall be promptly confirmed by the Parties by Confirmations exchanged by mail, telex, facsimile or other electronic means. The failure by a Party to issue a Confirmation shall not prejudice or invalidate the terms of any FX Transaction governed by the Agreement.

SECTION 3. SETTLEMENT AND NETTING

3.1. Settlement. Subject to Section 3.2, each Party shall deliver to the other Party the amount of the Currency to be delivered by it under each Currency Obligation on the Value Date for such Currency Obligation.

3.2. Net Settlement/Payment Netting. If on any Value Date more than one delivery of a particular Currency is to be made between a pair of Settlement Netting Offices, then each Party shall aggregate the amounts of such Currency deliverable by it and only the difference between these aggregate amounts shall be delivered by the Party owing the larger aggregate amount to the other Party, and, if the aggregate amounts are equal, no delivery of the Currency shall be made.

3.3. Novation Netting.

(a) By Currency. If the Parties enter into an FX Transaction governed by the Agreement through a pair of Novation Netting Offices giving rise to a Currency Obligation for the same Value Date and in the same Currency as a then existing Currency Obligation between the same pair of Novation Netting Offices, then immediately upon entering into such FX Transaction, each such Currency Obligation shall automatically and without further action be individually cancelled and simultaneously replaced by a new Currency Obligation for such Value Date determined as follows: the amounts of such Currency that would otherwise have been deliverable by each Party on such Value Date shall be aggregated and the Party with the larger aggregate amount shall have a new Currency Obligation to deliver to the other Party the amount of such Currency by which its aggregate amount exceeds the other Party's aggregate amount, provided that if the aggregate amounts are equal, no new Currency Obligation shall arise. This Clause (a) shall not affect any other Currency Obligation of a Party to deliver any different Currency on the same Value Date.

(b) By Matched Pair. If the Parties enter into an FX Transaction governed by the Agreement between a pair of Matched Pair Novation Netting Offices then the provisions of Section 3.3(a) shall apply only in respect of Currency Obligations arising by virtue of FX Transactions gov-

erned by the Agreement entered into between such pair of Matched Pair Novation Netting Offices and involving the same pair of Currencies and the same Value Date.

3.4. General.

(a) Inapplicability of Sections 3.2 and 3.3. The provisions of Sections 3.2 and 3.3 shall not apply if a Close-Out Date has occurred or an involuntary case of other proceeding of the kind described in Clause (iii) of the definition of Event of Default has occurred without being dismissed in relation to either Party.

(b) Failure to Record. The provisions of Section 3.3 shall apply notwithstanding that either Party may fail to record the new Currency Obligations in its books.

(c) Cutoff Date and Time. The provisions of Section 3.3 are subject to any cut-off date and cut-off time agreed between the applicable Novation Netting Offices and Matched Pair Novation Netting Offices of the Parties.

SECTION 4. REPRESENTATIONS, WARRANTIES AND COVENANTS

4.1. Representations and Warranties. Each Party represents and warrants to the other Party as of the date of the Agreement and as of the date of each FX Transaction governed by the Agreement that: (i) it has authority to enter into the Agreement and such FX Transaction; (ii) the persons executing the Agreement and entering into such FX Transaction have been duly authorized to do so; (iii) the Agreement and the Currency Obligations created under the Agreement are binding upon it and enforceable against it in accordance with their terms (subject to applicable principles of equity) and do not and will not violate the terms of any agreements to which such Party is bound; (iv) no Event of Default has occurred and is continuing with respect to it; and (v) it acts as principal in entering into each and every FX Transaction governed by the Agreement.

4.2. Covenants. Each Party covenants to the other Party that: (i) it will at all times obtain and comply with the terms of and do all that is necessary to maintain in full force and effect all authorizations, approvals, licenses and consents required to enable it to lawfully perform its obligations under the Agreement; and (ii) it will promptly notify the other Party of the occurrence of any Event of Default with respect to itself or any Credit Support Provider in relation to it.

SECTION 5. CLOSE-OUT AND LIQUIDATION

5.1. Circumstances of Close-Out and Liquidation. If an Event of Default has occurred and is continuing, then the Non-Defaulting Party shall have the right to close-out and liquidate in the manner described below all, but not less than all, outstanding Currency Obligations (except to the extent that in the good faith opinion of the Non-Defaulting Party certain of such Currency Obligations may not be closed-out and liquidated under applicable law), by notice to the Defaulting Party. If "Automatic Termination" is specified as applying to a Party in Part VI of the Schedule, then, in the case of an Event of Default specified in Clauses (ii) or (iii) of the definition thereof with respect to such Party, such close-out and liquidation shall be automatic as to all outstanding Currency Obligations. Where such close-out and liquidation is to be effected, it shall be effected by:

(i) closing out each outstanding Currency Obligation (including any Currency Obligation which has not been performed and in respect of which the Value Date is on or precedes the Close-Out Date) so that each such Currency Obligation is canceled and the Non-Defaulting Party shall calculate in good faith with respect to each such canceled Currency Obligation, the Closing Gain or, as appropriate, the Closing Loss, as follows:

(x) for each Currency Obligation in a Currency other than the Non-Defaulting Party's Base Currency calculate a "Close-Out Amount" by converting:

(A) in the case of a Currency Obligation whose Value Date is the same as or is later than the Close-Out Date, the amount of such Currency Obligation; or

(B) in the case of a Currency Obligation whose Value Date precedes the Close-Out Date, the amount of such Currency Obligation increased, to the extent permitted by applicable law, by adding interest thereto from the Value Date to the Close-Out Date at the rate representing the cost (expressed as a percentage rate per annum) at which the Non-Defaulting Party would have been able, on such Value Date, to fund the amount of such Currency Obligation for the period from the Value Date to the Close-Out Date

into such Base Currency at the rate of exchange at which the Non-Defaulting Party can buy or sell, as appropriate, such Base Currency with or against the Currency of such Currency Obligation for delivery on the Value Date of that Currency Obligation, or if such Value

Date precedes the Close-Out Date, for delivery on the Close-Out Date; and

(y) determine in relation to each Value Date: (A) the sum of all Close-Out Amounts relating to Currency Obligations under which, and of all Currency Obligations in the Non-Defaulting Party's Base Currency under which, the Non-Defaulting Party would otherwise have been obliged to deliver the relevant amount to the Defaulting Party on that Value Date, adding (to the extent permitted by applicable law), in the case of a Currency Obligation in the Non-Defaulting Party's Base Currency whose Value Date preceeds the Close-Out Date, interest for the period from the Value Date to the Close-Out Date at the Non-Defaulting Party's Base Currency Rate as at such Value Date for such period; and (B) the sum of all Close-Out Amounts relating to Currency Obligations under which, and of all Currency Obligations in the Non-Defaulting Party's Base Currency under which, the Non-Defaulting Party would otherwise have been entitled to receive the relevant amount on that Value Date, adding (to the extent permitted by applicable law), in the case of a Currency Obligation in the Non-Defaulting Party's Base Currency whose Value Date precedes the Close-Out-Date, interest for the period from the Value Date to the Close-Out Date at the Non-Defaulting Party's Base Currency Rate as at such Value Date for such period;

(z) if the sum determined under (y)(A) is greater than the sum determined under (y)(B), the difference shall be the Closing Loss for such Value Date; if the sum determined under (y)(A) is less than the sum determined under (y)(B), the difference shall be the Closing Gain for such Value Date;

(ii) to the extent permitted by applicable law, adjusting the Closing Gain or Closing Loss for each Value Date falling after the Close-Out Date to present value by discounting the Closing Gain or Closing Loss from the Value Date to the Close-Out Date, at the Non-Defaulting Party's Base Currency Rate, or at such other rate as may be prescribed by applicable law;

(iii) aggregating the following amounts so that all such amounts are netted into a single liquidated amount payable by or to the Non-Defaulting Party: (x) the sum of the Closing Gains for all Value Dates (discounted to present value, where appropriate, in accordance with the provisions of Clause (ii) of this Section 5.1)(which for the purposes of this aggregation shall be a positive figure) and (y) the sum of the Closing Losses for all Value Dates (discounted to present value, where appropriate, in accordance with the provisions of Clause (ii) of this Section

5.1)(which for the purposes of the aggregation shall be a negative figure); and

(iv) if the resulting net amount is positive, it shall be payable by the Defaulting Party to the Non-Defaulting Party, and if it is negative, then the absolute value of such amount shall be payable by the Non-Defaulting Party to the Defaulting Party.

5.2. Calculation of Interest. Any addition of interest or discounting required under Clause (i) or (ii) of Section 5.1 shall be calculated on the basis of the actual number of days elapsed and of a year of such number of days as is customary for transactions involving the relevant Currency in the relevant foreign exchange market.

5.3. Other FX Transactions. Where close-out and liquidation occurs in accordance with Section 5.1, the Non-Defaulting Party shall also be entitled to close-out and liquidate, to the extent permitted by applicable law, any other FX Transactions entered into between the Parties which are then outstanding in accordance with the provisions of Section 5.1, as if each obligation of a Party to deliver a Currency thereunder were a Currency Obligation.

5.4. Payment and Late Interest. The amount payable by one Party to the other Party pursuant to the provisions of Sections 5.1 and 5.3 shall be paid by the close of business on the Business Day following such close-out and liquidation (converted as required by applicable law into any other Currency, any costs of such conversion to be borne by, and deducted from any payment to, the amounts required to be paid under Sections 5.1 or 5.3 and not paid on the due date therefor, shall bear interest at the Non-Defaulting Party's Base Currency Rate plus 1% per annum (or, if conversion is required by applicable law into some other Currency, either (x) the average rate at which overnight deposits in such other Currency are offered by major banks in the London interbank market as of 11:00 a.m. (London time) plus 1% per annum or (y) such other rate as may be prescribed by such applicable law) for each day for which such amount remains unpaid.

5.5. Suspension of Obligations. Without prejudice to the foregoing, so long as a Party shall be in default in payment or performance to the Non-Defaulting Party under the Agreement and so long as the Non-Defaulting Party has not exercised its rights under Section 5.1, the Non-Defaulting Party may, at its election and without penalty, suspend its obligation to perform under the Agreement.

5.6. Expenses. The Defaulting Party shall reimburse the Non-Defaulting Party in respect of all out-of-pocket expenses incurred by the Non-Defaulting Party (including fees and disbursements of counsel,

including attorneys who may be employees of the Non-Defaulting Party) in connection with any reasonable collection or other enforcement proceedings related to the payments required under this Section 5.

5.7. Reasonable Pre-Estimate. The Parties agree that the amounts recoverable under this Section 5 are a reasonable pre-estimate of loss and not a penalty. Such amounts are payable for the loss of bargain and the loss of protection against future risks and, except as otherwise provided in the Agreement, neither Party will be entitled to recover any additional damages as a consequence of such losses.

5.8. No Limitation of Other Rights; Set-Off. The Non-Defaulting Party's rights under this Section 5 shall be in addition to, and not in limitation or exclusion of, any other rights which the Non-Defaulting Party may have (whether by agreement, operation of law or otherwise). To the extent not prohibited by applicable law, the Non-Defaulting Party shall have a general right of set-off with respect to all amounts owed by each Party to the other Party, whether due and payable or not due and payable (provided that any amount not due and payable at the time of such set-off shall, if appropriate, be discounted to present value in a commercially reasonable manner by the Non-Defaulting Party). The Non-Defaulting Party's rights under this Section 5.8 are subject to Section 5.7.

SECTION 6. ILLEGALITY, IMPOSSIBILITY AND FORCE MAJEURE

If either Party is prevented from or hindered or delayed by reason of force majeure or act of State in the delivery or receipt of any Currency in respect of a Currency Obligation or if it becomes or, in the good faith judgment of one of the Parties, may become unlawful or impossible for either Party to deliver or receive any Currency which is the subject of a Currency Obligation, then either Party may, by notice to the other Party, require the close-out and liquidation of each affected Currency Obligation in accordance with the provisions of Sections 5.1, 5.2 and 5.4 and, for the purposes of enabling the calculations prescribed by Sections 5.1, 5.2 and 5.4 to be effected, the Party unaffected by such force majeure, act of State, illegality or impossibility (or if both Parties are so affected, whichever Party gave the relevant notice) shall effect the relevant calculations as if it were the Non-Defaulting Party. Nothing in this Section 6 shall be taken as indicating that the Party treated as the Defaulting Party for the purposes of calculations required hereby has committed any breach of default.

SECTION 7. PARTIES TO RELY ON THEIR OWN EXPERTISE

Each Party shall enter into each FX Transaction governed by the Agreement in reliance only upon its own judgment. Neither Party holds itself out as advising, or any of its employees or agents as having the authority to advise, the other Party as to whether or not it should enter into any such FX Transaction or as to any subsequent actions relating thereto or on any other commercial matters concerned with any FX Transaction governed by the Agreement, and neither Party shall have any responsibility or liability whatsoever in respect of any advice of this nature given, or views expressed, by it or any of such persons to the other Party, whether or not such advice is given or such views are expressed at the request of the other Party.

SECTION 8. MISCELLANEOUS

8.1. Currency Indemnity. The receipt or recovery by either Party (the "first Party") of any amount in respect of an obligation of the other Party (the "second Party") in a Currency other than that in which such amount was due, whether pursuant to a judgment of any court or pursuant to Section 5 or 6, shall discharge such obligation only to the extent that on the first day on which the first Party is open for business immediately following such receipt, the first Party shall be able, in accordance with normal banking practice, to purchase the Currency in which such amount was due with the Currency received. If the amount so purchasable shall be less than the original amount of the Currency in which such amount was due, the second Party shall, as a separate obligation and notwithstanding any judgment of any court, indemnify the first Party against any loss sustained by it. The second Party shall in any event indemnify the first Party against any costs incurred by it in making any such purchase of Currency.

8.2. Assignments. Neither Party may assign, transfer or charge, or purport to assign, transfer or charge, its rights or its obligations under the Agreement or any interest therein without the prior written consent of the other Party, and any purported assignment, transfer or charge in violation of this Section 8.2 shall be void.

8.3. Telephonic Recording. The Parties agree that each may electronically record all telephonic conversations between them and that any such tape recordings may be submitted in evidence in any Proceedings relating to the Agreement. In the event of any dispute between the Parties as to the terms of an FX Transaction governed by the Agreement of the Currency Obligations thereby created the Parties may use electronic recordings between the persons who entered into such FX Transaction as

the preferred evidence of the terms of such FX Transaction, notwithstanding the existence of any writing to the contrary.

8.4. No Obligation. Neither Party to this Agreement shall be required to enter into any FX Transaction with the other.

8.5. Notices. Unless otherwise agreed, all notices, instructions and other communications to be given to a Party under the Agreement shall be given to the address, telex (if confirmed by the appropriate answerback), facsimile (confirmed if requested) or telephone number and to the individual or department specified by such Party in Part VII of the Schedule attached hereto. Unless otherwise specified, any notice, instruction or other communication given in accordance with this Section 8.5 shall be effective upon receipt.

8.6. Termination. Each of the Parties hereto may terminate this Agreement at any time by seven days' prior written notice to the other Party delivered as prescribed above, and termination shall be effective at the end of such seventh day; provided, however, that any such termination shall not affect any outstanding Currency Obligations, and the provisions of the Agreement shall continue to apply until all the obligations of each Party to the other under the Agreement have been fully performed.

8.7. Severability. In the event any one or more of the provisions contained in the Agreement should be held invalid, illegal or unenforceable in any respect under the law of any jurisdiction, the validity, legality and enforceability of the remaining provisions under the law of such jurisdiction, and the validity, legality and enforceability of such and any other provisions under the law of any other jurisdiction, shall not in any way be affected or impaired thereby.

8.8. Waiver. No indulgence or concession granted by a Party and no omission or delay on the part of a Party in exercising any right, power or privilege under the Agreement shall operate as a waiver thereof, nor shall any single or partial exercise of any such right, power or privilege preclude any other or further exercise thereof or the exercise of any other right, power or privilege.

8.9. Master Agreement. Where one of the Parties to the Agreement is domiciled in the United States, the Parties intend that the Agreement shall be a master agreement, as defined in 11 U.S.C. Section 101(55)(C) and 12 U.S.C. Section 1821(e)(8)(D)(vii).

8.10. Time of Essence. Time shall be of the essence in the Agreement.

8.11. Headings. Headings in the Agreement are for ease of reference only.

<u>8.12. Wire Transfers.</u> Every payment or delivery of Currency to be made by a Party under the Agreement shall be made by wire transfer, or its equivalent, of same day (or immediately available) and freely transferable funds to the bank account designated by the other Party for such purpose.

<u>8.13. Adequate Assurances.</u> If the Parties have so agreed in Part X of the Schedule, the failure by a Party ("first Party") to give adequate assurances of its ability to perform any of its obligations under the Agreement within two (2) Business Days of a written request to do so when the other Party ("second Party") has reasonable grounds for insecurity shall be an Event of Default under the Agreement, in which case during the pendency of a reasonable request by the second Party to the first Party for adequate assurances of the first Party's ability to perform its obligations under the Agreement, the second Party may, at its election and without penalty, suspend its obligations under the Agreement.

<u>8.14. FDICIA Representation.</u> If the Parties have so agreed in Part XI of the Schedule, each Party represents and warrants to the other Party that it is a financial institution under the provisions of Title IV of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), and the Parties agree that this Agreement shall be a netting contract, as defined in FDICIA, and each receipt or payment or delivery obligation under the Agreement shall be a covered contractual payment entitlement or covered contractual payment obligation, respectively, as defined in and subject to FDICIA.

<u>8.15. Confirmation Procedures.</u> In relation to Confirmations, unless either Party objects to the terms contained in any Confirmation within three (3) Business Days of receipt thereof, or such shorter time as may be appropriate given the Value Date of the FX Transaction, the terms of such Confirmation shall be deemed correct and accepted absent manifest error, unless a corrected Confirmation is sent by a Party within such three Business Days, or shorter period, as appropriate, in which case the Party receiving such corrected Confirmation shall have three (3) Business Days, or shorter period, as appropriate, after receipt thereof to object to the terms contained in such corrected Confirmation. In the event of any conflict between the terms of a Confirmation and this Master Agreement, the terms of the Master Agreement shall prevail, and the Confirmation shall not modify the terms of this Master Agreement.

<u>8.16. Amendments.</u> No amendment, modification or waiver of the Agreement will be effective unless in writing executed by each of the Parties.

SECTION 9. LAW AND JURISDICTION

9.1. Governing Law. The Agreement shall be governed by, and construed in accordance with the laws of [the State of New York][England and Wales] without giving effect to conflict of laws provisions.

9.2. Consent to Jurisdiction. With respect to any Proceedings, each Party irrevocably (i) [submits to the non-exclusive jurisdiction of the courts of the State of New York and the United States District Court located in the Borough of Manhattan in New York City,][agrees for the benefit of the other Party that the courts of England shall have jurisdiction to determine any Proceedings and irrevocably submits to the jurisdiction of the English courts], and (ii) waives any objection which it may have at any time to the laying of venue of any Proceedings brought in any such court, waives any claim that such Proceedings have been brought in an inconvenient forum and further waives the right to object, with respect to such Proceedings, that such court does not have jurisdiction over such Party. Nothing in the Agreement precludes either Party from bringing Proceedings in any other jurisdiction nor will the bringing of Proceedings in any one or more jurisdictions preclude the bringing of Proceedings in any other jurisdiction.

9.3. Waiver of Immunities. Each Party irrevocably waives to the fullest extent permitted by applicable law, with respect to itself and its revenues and assets (irrespective of their use or intended use) all immunity on the grounds of sovereignty or other similar grounds from (i) suit, (ii) jurisdiction of any courts, (iii) relief by way of injunction, order for specific performance or for recovery of property, (iv) attachment of its assets (whether before or after judgment) and (v) execution or enforcement of any judgment to which it or its revenues or assets might otherwise be entitled in any Proceedings in the courts of any jurisdiction, and irrevocably agrees to the extent permitted by applicable law that it will not claim any such immunity in any Proceedings. Each Party consents generally in respect of any Proceedings to the giving of any relief or the issue of any process in connection with such Proceedings, including, without limitation, the making, enforcement or execution against any property whatsoever of any order or judgment which may be made or given in such Proceedings.

9.4. Waiver of Jury Trial. Each Party hereby irrevocably waives any and all right to trial by jury in any Proceedings.

IN WITNESS WHEREOF, the Parties have caused the Agreement to be duly executed by their respective authorized officers as of the first date written above.

____

By ______________________
Name:
Title:

____

By ______________________
Name:
Title:

Schedule

Part I. Scope of Agreement

The Agreement shall apply to [all][the following] FX Transactions outstanding between any two Designated Offices of the Parties on the Effective Date.

Part II: Designated Offices

Each of the following shall be a Designated Office:

Part III: Settlement Netting Offices

Net settlement provisions of Section 3.2 shall apply to the following Settlement Netting Offices:

Part IV: Novation Netting Offices

Netting by novation provisions of Section 3.3(a) shall apply to the following Novation Netting Offices and shall apply to [all FX Transactions][FX Transactions with a Value Date more than two Business Days after the day on which the Parties enter into an FX Transaction]:

Part V: Matched Pair Novation Netting Offices

Matched pair netting by novation provisions of Section 3.3(b) shall apply to the following Matched Pair Novation Netting Offices and shall apply to [all FX Transactions][FX Transactions with a Value Date more than two Business Days after the day on which the Parties enter into an FX Transaction]:

Part VI: Automatic Termination

The "Automatic Termination" provision in Section 5.1 _______ [shall][shall not] apply to_______and [shall][shall not] apply to_______

Part VI: Notices

Address:
Telephone Numbers:
Telex Number:
Facsimile Numbers:
Name of Individual of Department to Whom Notices Are to Be Sent:

Part VII: Base Currency

Part IX: Threshold Amount

The Threshold Amount applicable to ____________ shall be:

The Threshold Amount applicable to ____________ shall be:

Part X: Adequate Assurances

The provisions of Section 8.13 [shall][shall not] apply to the Agreement.

Part XI: FDICIA Representations

The provisions of Section 8.14 [shall][shall not] apply to the Agreement.

Appendix II

2 International Currency Options Market (ICOM) Master Agreement

INTERNATIONAL CURRENCY OPTIONS MARKET MASTER AGREEMENT[1]

MASTER AGREEMENT dated as of ______ , 19__ , by and between ________________, a ________________ , and ____________________ , a ______________ .

1. DEFINITIONS

In this Agreement, unless otherwise required by the context, the following terms shall have the following meanings:

"American Style Option"	An Option which may be exercised on any Business Day up to and including the Expiration Time;
"Base Currency"	The currency specified as such by a Party in Part IV of the Schedule hereto;
"Base Currency Rate"	For any day, the average rate at which overnight deposits in the Base Currency are offered by major banks in the London interbank market as of 11:00 a.m. (London time) on such day or such other rate as shall be agreed by the Parties, in either case as determined in good faith by the Non-Defaulting Party;
"Business Day"	For purposes of: (i) Section 4.2 hereof, a day which is a Local Banking Day for the applicable Designated Office of the Buyer; (ii) Section 5.1 hereof and the definition of American Style Option and Exercise Date, a day which is a Local Banking Day for the applicable Designated Office of the Seller; (iii) the definition of Event of Default, a day which is a Local Banking Day for

[1] This text is reproduced with permission from the Foreign Exchange Committee. It was prepared by the British Banker's Association and the Foreign Exchange Committee and is dated April 1992.

	the Non-Defaulting Party; and (iv) any other provision hereof, a day which is a Local Banking Day for the applicable Designated Office of both Parties; provided, however, that neither Saturday nor Sunday shall be considered a Business Day hereunder for any purpose;
"Buyer"	The owner of an Option;
"Call"	An option entitling, but not obligating, the Buyer to purchase from the Seller at the Strike Price a specified quantity of the Call Currency;
"Call Currency"	The currency agreed as such at the time an Option is entered into;
"Confirmation"	A confirmation of an Option substantially in the form of Exhibit I hereto, which confirmation shall be in writing (which shall include telex or other electronic means from which it is possible to produce a hard copy);
"Currency Pair"	The two currencies which may be potentially exchanged upon the exercise of an Option, one of which shall be the Put Currency and the other the Call Currency;
"Designated Office"	As to either Party, the office or offices specified on Part I of the Schedule hereto and any other office specified from time to time by one Party and agreed to by the other as an amendment hereto as a Designated Office on Part I of the Schedule hereto;
"European Style Option"	An Option for which Notice of Exercise may be given only on the Option's Expiration Date up to and including the Expiration Time, unless otherwise agreed;
"Event of Default"	The occurrence of any of the following with respect to a Party (the "Defaulting Party"): (i) the Defaulting Party shall default in any payment hereunder (including, but not limited to, a Premium payment) to the other Party (the "Non-Defaulting Party") with respect to any Option and such failure shall continue for two (2) Business Days after written notice of non-payment by the Non-Defaulting Party; (ii) the

Defaulting Party shall commence a voluntary case or other proceeding seeking liquidation, reorganization or other relief with respect to itself or to its debts under any bankruptcy, insolvency or similar law, or seeking the appointment of a trustee, receiver, liquidator, conservator, administrator, custodian or other similar official (each, a "Custodian") of it or any substantial part of its assets; or shall take any corporate action to authorize any of the foregoing; (iii) an involuntary case or other proceeding shall be commenced against the Defaulting Party seeking liquidation, reorganization or other relief with respect to it or its debts under any bankruptcy, insolvency or other similar law or seeking the appointment of a Custodian of it or any substantial part of its assets; (iv) the Defaulting Party is bankrupt or insolvent; (v) the Defaulting Party shall otherwise be unable to pay its debts as they become due; (vi) the failure by the Defaulting Party to give adequate assurances of its ability to perform its obligations with respect to an Option within two (2) Business Days of a written request to do so when the Non-Defaulting Party has reasonable grounds for insecurity; (vii) the Defaulting Party of any Custodian acting on behalf of the Defaulting Party shall disaffirm or repudiate any Option; or (viii) any representation or warranty made or deemed made pursuant to Section 3 of this Agreement by the Defaulting Party shall prove to have been false or misleading in any material respect as at the time it was made or given or deemed made or given and the Non-Defaulting Party shall have given the Defaulting Party one (1) Business Day's prior written notice thereof;

"Exercise Date" — The Business Day on which a Notice of Exercise received by the applicable Designated Office of the Seller becomes effective pursuant to Section 5.1;

"Expiration Date" — The date specified as such in a Confirmation;

"Expiration Time" — The latest time on the Expiration Date on which the Seller must accept a Notice of Exercise as specified in a Confirmation;

"In-the-money Amount"	(i) In the case of a Call, the excess of the Spot Price over the Strike Price, multiplied by the aggregate amount of the Call Currency to be purchased under the Call, where both prices are quoted in terms of the amount of the Put Currency to be paid for one unit of the Call Currency; and (ii) in the case of a Put, the excess of the Strike Price over the Spot Price, multiplied by the aggregate amount of the Put Currency to be sold under the Put, where both prices are quoted in terms of the amount of the Call Currency to be paid for one unit of the Put Currency;
"Local Banking Day"	For any currency or Party, a day on which commercial banks in the principal banking center of the country of issuance of such currency or in the location of the applicable Designated Office of such Party, respectively, are not authorized or required by law to close;
"Notice of Exercise"	Telex, telephonic or other electronic notification (excluding facsimile transmission), providing assurance of receipt, given by the Buyer prior to or at the Expiration Time, of the exercise of an Option, which notification shall be irrevocable;
"Option"	A Put or a Call, as the case may be, including any unexpired Put or Call previously entered into by the Parties, which shall be or become subject to this Agreement unless otherwise agreed;
"Parties"	The parties to this Agreement; and the term "Party" shall mean whichever of the Parties is appropriate in the context in which such expression may be used;
"Premium"	The purchase price of the Option as agreed upon by the Parties, and payable by the Buyer to the Seller thereof;
"Premium Payment Date"	The date specified as such in the Confirmation;
"Put"	An option entitling, but not obligating, the Buyer to sell to the Seller at the Strike Price a specified quantity of the Put Currency;

"Put Currency"	The currency agreed as such at the time an Option is entered into;
"Seller"	The Party granting an Option;
"Settlement Date"	In respect of: (i) an American Style Option, the Spot Date of the Currency Pair on the Exercise Date of such Option; and (ii) a European Style Option, the Spot Date of the Currency Pair on the Expiration Date of such Option;
"Spot Date"	The spot delivery day for the relevant Currency Pair as generally used by the foreign exchange market;
"Spot Price"	The price at the time at which such price is to be determined for foreign exchange transactions in the relevant Currency Pair for value on the Spot Date, as determined in good faith: (i) by the Seller, for purposes of Section 5 hereof; and (ii) by the Non-Defaulting Party, for purposes of Section 8 hereof;
"Strike Price"	The price specified in a Confirmation at which the Currency Pair may be exchanged.

2. GENERAL

2.1 The Parties (through their respective Designated Offices) may enter into Options (neither being obliged to do so) for such Premiums, with such Expiration Dates, at such Strike Prices and for the purchase or sale of such quantities of such currencies, as may be agreed subject to the terms hereof.

2.2 Each Option shall be governed by the terms and conditions set forth in this Master Agreement and in the Confirmation relating to such Option. Each Confirmation shall supplement and form a part of this Master Agreement and shall be read and construed as one with this Master Agreement and with each other Confirmation, so that this Master Agreement and all Confirmations, Schedules and amendments hereto constitute a single agreement between the Parties (collectively referred to as this "Agreement"). The Parties acknowledge that all Options are entered into in reliance upon such fact, it being understood that the Parties would not otherwise enter into any Option.

2.3 Options shall be promptly confirmed by the Parties by Confirmations exchanged by mail, telex, facsimile or other

electronic means. Unless either Party objects to the terms contained in any Confirmation within the earlier of (i) the time period recognized by local market practice or (ii) three (3) Business Days of receipt thereof, the terms of such Confirmation shall be deemed correct absent manifest error, unless a corrected Confirmation is sent by a Party within such three day period, in which case the Party receiving such corrected Confirmation shall have three (3) Business Days after receipt thereof to object to the terms contained in such corrected Confirmation. Failure by either Party to issue a Confirmation shall not alter the rights and obligations of either Party under an Option to which the Parties have agreed. In the event of any conflict between the terms of a Confirmation and this Agreement, such Confirmation shall prevail, except for purposes of this Section 2.3 and Section 6 hereof.

2.4 Neither Party may assign its rights nor delegate its obligations under any Option to a third party without the prior written consent of the other Party.

3. REPRESENTATIONS AND WARRANTIES; CONTRACTUAL STATUS

Each Party represents and warrants to the other Party as of the date hereof and as of the date of each Option that: (i) it has authority to enter into this Master Agreement and such Option; (ii) the persons executing this Master Agreement and entering into such Option on its behalf have been duly authorized to do so; (iii) this Master Agreement and such Option are binding upon it and enforceable against it in accordance with their respective terms and do not and will not violate the terms of any agreements to which such Party is bound; (iv) no Event of Default, or event which, with notice or lapse of time or both, would constitute an Event of Default has occurred and is continuing with respect to it; and (v) it acts as principal in entering into and exercising each and every Option.

4. THE PREMIUM

4.1 Unless otherwise agreed in writing by the Parties, the Premium related to an Option shall be paid on its Premium Payment Date.

4.2 If any Premium is not received on the Premium Payment Date, the Seller may elect either: (i) to accept a late payment of such Premium; (ii) to give written notice of such non-payment and, if such payment shall not be received within two (2) Business Days of such notice, treat the related Option as void; or (iii) to give written notice of such non-payment and, if such payment shall

not be received within two (2) Business Days of such notice, treat such non-payment as an Event of Default under clause (i) of the definition of Event of Default. If the Seller elects to act under either clause (i) or (ii) of the preceding sentence, the Buyer shall pay all out-of-pocket costs and actual damages incurred in connection with such unpaid or late Premium or void Option, including, without limitation, interest on such Premium in the same currency as such Premium at the then prevailing market rate and any other costs or expenses incurred by the Seller in covering its obligations (including, without limitation, a delta hedge) with respect to such Option.

5. EXERCISE AND SETTLEMENT OF OPTIONS

5.1 The Buyer may exercise an Option by delivery to the Seller of a Notice of Exercise. Subject to Section 5.4 hereof, if an Option has not been exercised prior to or at the Expiration Time, it shall expire and become void and of no effect. Any Notice of Exercise shall (unless otherwise agreed): (i) if received prior to 3:00 p.m. on a Business Day, be effective upon receipt thereof by the Seller; and (ii) if received after 3:00 p.m. on a Business Day, be effective only as of the opening of business of the Seller on the first Business Day subsequent to its receipt.

5.2 An exercised Option shall settle on its Settlement Date. Subject to Sections 5.3 and 5.4 hereof, on the Settlement Date, the Buyer shall pay the Put Currency to the Seller for value on the Settlement Date and the Seller shall pay the Call Currency to the Buyer for value on the Settlement Date.

5.3 An Option shall be settled at its In-the-money Amount if so agreed by the Parties at the time such Option is entered into. In such case, the In-the-money Amount shall be determined based upon the Spot Price at the time of exercise or as soon thereafter as possible. The sole obligations of the Parties with respect to such Option shall be to deliver or receive the In-the-money Amount of such Option on the Settlement Date.

5.4 Unless the Seller is otherwise instructed by the Buyer, if an Option has an In-the-money Amount at its Expiration Time that equals or exceeds the product of (x) 1% of the Strike Price and (y) the amount of the Call or Put Currency, as appropriate, then the Option shall be deemed automatically exercised. In such case, the Seller may elect to settle such Option either in accordance with Section 5.2 of this Agreement or by payment to the Buyer on the Settlement Date for such Option of the In-the-

money Amount, as determined at the Expiration Time or as soon thereafter as possible. In the latter case, the sole obligations of the Parties with respect to such Option shall be to deliver or receive the In-the-money Amount of such Option on the Settlement Date. The Seller shall notify the Buyer of its election of the method of settlement of an automatically exercised Option as soon as practicable after the Expiration Time.

5.5 Unless otherwise agreed by the Parties, an Option may be exercised only in whole.

6. DISCHARGE AND TERMINATION OF OPTIONS

Unless otherwise agreed, any Call Option or any Put Option written by a Party will automatically be terminated and discharged, in whole or in part, as applicable, against a Call Option or a Put Option, respectively, written by the other Party, such termination and discharge to occur automatically upon the payment in full of the last Premium payable in respect of such Options; provided that such termination and discharge may only occur in respect of Options:

(a) each being with respect to the same Put Currency and the same Call Currency;

(b) each having the same Expiration Date and Expiration Time;

(c) each being of the same style, i.e. either both being American Style Options or both being European Style Options;

(d) each having the same Strike Price; and

(e) neither of which shall have been exercised by delivery of a Notice of Exercise;

and, upon the occurrence of such termination and discharge, neither Party shall have any further obligation to the other Party in respect of the relevant Options or, as the case may be, parts thereof so terminated and discharged. In the case of a partial termination and discharge (i.e., where the relevant Options are for different amounts of the Currency Pair), the remaining portion of the Option which is partially discharged and terminated shall continue to be an Option for all purposes of this Agreement, including this Section 6.

7. PAYMENT NETTING

7.1 If, on any date, and unless otherwise mutually agreed by the Parties, Premiums would otherwise be payable hereunder in the same currency between respective Designated Offices of the

Parties, then, on such date, each Party's obligation to make payment of any such Premium will be automatically satisfied and discharged and, if the aggregate Premium(s) that would otherwise have been payable by such Designated Office of one Party exceeds the aggregate Premium(s) that would otherwise have been payable by such Designated Office of the other Party, replaced by an obligation upon the Party by whom the larger aggregate Premium(s) would have been payable to pay the other Party the excess of the larger aggregate Premium(s) over the smaller aggregate Premium(s).

7.2 If, on any date, and unless otherwise mutually agreed by the Parties, amounts other than Premium payments would otherwise be payable hereunder in the same currency between respective Designated Offices of the Parties, then, on such date, each Party's obligation to make payment of any such amount will be automatically satisfied and discharged and, if the aggregate amount that would otherwise have been payable by such Designated Office of one Party exceeds the aggregate amount that would otherwise have been payable by such Designated Office of the other Party, replaced by an obligation upon the Party by whom the larger aggregate amount would have been payable to pay the other Party the excess of the larger aggregate amount over the smaller aggregate amount.

8. DEFAULT

8.1 If an Event of Default has occurred and is continuing, then the Non-Defaulting Party shall have the right to liquidate and/or to deem to liquidate all, but not less than all (except to the extent that in the good faith opinion of the Non-Defaulting Party certain of such Options may not be liquidated under applicable law), outstanding Options by notice to the Defaulting Party. The previous sentence notwithstanding, in the case of an Event of Default specified in clauses (ii), (iii) or (iv) of the definition thereof, such liquidation and/or deemed liquidation shall be automatic as to all outstanding Options, except where the relevant voluntary or involuntary case or other proceeding or bankruptcy or insolvency giving rise to such Event of Default is governed by a system of law which contains express provisions enabling close-out in the manner described in clauses (i) to (iv) below (or a manner equivalent thereto) to take place after the occurrence of the relevant Event of Default in the absence of automatic liquidation. Such liquidation and/or deemed liquidation shall be effected by:

(i) closing out each such Option at the same time of liquidation so that each such Option is canceled and market damages for each Party are calculated equal to the aggregate of (a) with respect to each Option purchased by such Party, the current market premium for such Option, (b) with respect to each Option sold by such Party, any unpaid Premium and, to the extent permitted by applicable law, interest on any unpaid Premium in the same currency as such Premium at the then prevailing market rate, (c) with respect to any exercised Option, any unpaid amount due in settlement of such Option and, to the extent permitted by applicable law, interest thereon from the applicable Settlement Date to the day of close-out at the average rate at which overnight deposits in the currency in which such unpaid amount was due are offered by major banks in the London interbank market as of 11:00 a.m. (London time) on each such day plus 1% per annum, and (d) any costs or expenses incurred by the Non-Defaulting Party in covering its obligations (including a delta hedge) with respect to such Option, all as determined in good faith by the Non-Defaulting Party;

(ii) converting any damages calculated in accordance with clause (i) above in a currency other than the Non-Defaulting Party's Base Currency into such Base Currency at the Spot Price at which, at the time of liquidation, the Non-Defaulting Party could enter into a contract in the foreign exchange market to buy the Base Currency in exchange for such currency;

(iii) netting such damage payments with respect to each Party so that all such amounts are netted to a single liquidated amount payable by one Party to the other Party as a settlement payment; and

(iv) setting off the net payment calculated in accordance with clause (iii) above which the Non-Defaulting Party owes to the Defaulting Party, if any, and, at the option of the Non-Defaulting Party, any margin or other collateral ("Margin") held by the Non-Defaulting Party (including the liquidated value of any non-cash Margin) in respect of the Defaulting Party's obligations hereunder against the net payment calculated in accordance with clause (iii) above which the Defaulting Party owes to the Non-Defaulting Party, if any, and, at the option of the Non-Defaulting Party, any Margin held by the Defaulting Party (including the liquidated value of any non-

cash Margin) in respect of the Non-Defaulting Party's obligations hereunder; provided, that, for purposes of such set-off, any Margin denominated in a currency other than the Non-Defaulting Party's Base Currency shall be converted into such currency at the rate specified in clause (ii) above.

8.2 The net amount payable by one Party to the other Party pursuant to the provisions of Section 8.1 above shall be paid by the close of business on the Business Day following such liquidation and/or deemed liquidation of all such Options (converted as required by applicable law into any other currency, any such costs of conversion to be borne by, and deducted from any payment to, the Defaulting Party). To the extent permitted by applicable law, any amounts owed but not paid when due under this Section 8 shall bear interest at the Base Currency Rate plus 1% per annum (or, if conversion is required by applicable law into some other currency, either (x) the average rate at which overnight deposits in such other currency are offered by major banks in the London interbank market as of 11:00 a.m. (London time) plus 1% per annum or (y) such other rate as may be prescribed by such applicable law) for each day for which such amount remains unpaid.

8.3 Without prejudice to the foregoing, so long as a Party shall be in default in payment or performance to the other Party hereunder or under any Option and the Non-Defaulting Party has not exercised its rights under this Section 8, or during the pendency of a reasonable request to a Party for adequate assurances of its ability to perform its obligations hereunder or under any Option, the other Party may, at its election and without penalty, suspend its obligation to perform hereunder or under any Option.

8.4 The Party required to make a payment to the other Party pursuant to Sections 8.1 and 8.2 above shall pay to the other Party all out-of-pocket expenses incurred by such other Party (including fees and disbursements of counsel and time charges of attorneys who may be employees of such other Party) in connection with any reasonable collection or other enforcement proceedings related to such required payment.

8.5 The Parties agree that the amounts recoverable under this Section 8 are a reasonable pre-estimate of loss and not a penalty. Such amounts are payable for the loss of bargain and the loss of protection against future risks and, except as otherwise provided in this Agreement, neither Party will be entitled to recover any additional damages as a consequence of such losses.

8.6 The Non-Defaulting Party's rights under this Section 8 shall be in addition to, and not in limitation or exclusion of, any other rights which the Non-Defaulting Party may have (whether by agreement, operation of law or otherwise), and the Non-Defaulting Party shall have a general right of set-off with respect to all amounts owed by each party to the other Party, whether due or not due (provided that any amount not due at the time of such set-off shall be discounted to present value in a commercially reasonable manner by the Non-Defaulting Party).

9. PARTIES TO RELY ON THEIR OWN EXPERTISE

Each Option shall be deemed to have been entered into by each Party in reliance only upon its judgment. Neither Party holds out itself as advising, or any of its employees or agents as having its authority to advise, the other Party as to whether or not it should enter into any such Option (whether as Seller or Buyer) or as to any subsequent actions relating thereto or on any other commercial matters concerned with any currency options or transactions, and neither Party shall have any responsibility or liability whatsoever in respect of any advice of this nature given, or views expressed, by it or any of such persons to the other Party, whether or not such advice is given or such views are expressed at the request of the other Party.

10. ILLEGALITY, IMPOSSIBILITY AND FORCE MAJEURE

If either Party is prevented from or hindered or delayed by reason of force majeure or act of State in the delivery or payment of any currency in respect of an Option or if it becomes unlawful or impossible for either Party to make or receive any payment in respect of an Option, then the Party for whom such performance has been prevented, hindered or delayed or has become illegal or impossible shall promptly give notice thereof to the other Party and either Party may, by notice to the other Party, require the liquidation and close-out of each affected Option in accordance with the provisions of Section 8 hereof and, for such purposes, the Party unaffected by such force majeure, act of State, illegality or impossibility shall be considered the Non-Defaulting Party and, for purposes of this Section 10, such Non-Defaulting Party shall perform the calculation required under Section 8.

11. MISCELLANEOUS

11.1 Unless otherwise specified, the times referred to herein shall in each case refer to the local time of the relevant Designated Office of the Seller of the relevant Option.

11.2 Unless otherwise specified, all notices, instructions and other communications to be given to a Party hereunder shall be given to the address, telex (if confirmed by the appropriate answerback), facsimile (confirmed if requested) or telephone number and to the individual or Department specified by such Party in Part II of the Schedule attached hereto. Unless otherwise specified, any notice, instruction or other communication, shall be effective upon receipt if given in accordance with this Section 11.2.

11.3 All payments to be made hereunder shall be made in same day (or immediately available) and freely transferable funds and, unless otherwise specified, shall be delivered to such office of such bank and in favor of such account as shall be specified by the Party entitled to receive such payment in Part III of the Schedule attached hereto or as specified by such Party by notice given in accordance with Section 11.2. Time shall be of the essence in this Agreement.

11.4 The receipt or recovery by either Party of any amount in respect of an obligation of the other Party in a currency other than the Base Currency (other than receipt by the Defaulting Party pursuant to Sections 8.1 and 8.2 of a payment in the Non-Defaulting Party's Base Currency), whether pursuant to a judgment of any court or pursuant to Section 8 hereof, shall discharge such obligation only to the extent that, on the first day on which such party is open for business immediately following such receipt, the recipient shall be able, in accordance with normal banking procedures, to purchase the Base Currency with the currency received. If the amount of the Base Currency purchasable shall be less than the original Base Currency amount calculated pursuant to Section 8 hereof, the obligor shall, as a separate obligation and notwithstanding any judgment of any court, indemnify the recipient against any loss sustained by it. The obligor shall in any event indemnify the recipient against any costs incurred by it in making any such purchase of the Base Currency.

11.5 The Parties agree that each may electronically record all telephonic conversations between them and that any such recordings may be submitted in evidence to any court or in any proceeding for the purpose of establishing any matters pertinent to any Option.

11.6 This Agreement shall supersede any other agreement between the Parties with respect to the subject matter hereof and all

outstanding Options between the Parties on the date hereof shall be subject hereto, unless otherwise expressly agreed by the Parties.

11.7 A margin agreement between the Parties may apply to obligations governed by this Agreement. If the Parties have executed a margin agreement, such margin agreement shall be subject to the terms hereof and is hereby incorporated by reference herein. In the event of any conflict between a margin agreement and this Agreement, this Agreement shall prevail, except for any provision in such margin agreement in respect of governing law.

11.8 In the event any one or more of the provisions contained in this Agreement should be held invalid, illegal or unenforceable in any respect, the validity, legality and enforceability of the remaining provisions contained herein shall not in any way be affected or impaired thereby. The Parties shall endeavor in good faith negotiations to replace the invalid, illegal or unenforceable provisions with valid provisions the economic effect of which comes as close as possible to that of the invalid, illegal or unenforceable provisions.

12. LAW AND JURISDICTION

12.1 This Agreement shall be governed by, and construed in accordance with, the laws of [the State of New York] [England and Wales] without giving effect to conflicts of law principles.

12.2 With respect to any suit, action or proceedings ("Proceedings") relating to any Option or this Agreement, each Party irrevocably (i) [submits to the non-exclusive jurisdiction of the courts of the State of New York and the United States District Court located in the Borough of Manhattan in New York City,] [agrees for the benefit of the other Party that the courts of England shall have jurisdiction to determine any Processing and irrevocably submits to the jurisdiction of the English courts] and (ii) waives any objection which it may have at any time to the laying of venue of any Proceedings brought in any such court, waives any claim that such Proceedings have been brought in an inconvenient forum and further waives the right to object, with respect to such Proceedings, that such court does not have jurisdiction over such Party. Nothing in this Agreement precludes either Party from bringing Proceedings in any other jurisdiction nor will

the bringing of Proceedings in any one or more jurisdictions preclude the bringing of Proceedings in any other jurisdiction.

12.3 Each Party hereby irrevocably waives any and all right to trial by jury in any legal proceeding arising out of or relating to this Agreement or any Option.

12.4 Each Party hereby irrevocably waives, to the fullest extent permitted by applicable law, with respect to itself and its revenues and assets (irrespective of their use or intended use), all immunity on the grounds of sovereignty or other similar grounds from (i) suit, (ii) jurisdiction of any court, (iii) relief by way of injunction, order for specific performance or for recovery of property, (iv) attachment of its assets (whether before or after judgment) and (v) execution or enforcement of any judgment to which it or its revenues or assets might otherwise be entitled in any Proceedings (as defined in Section 12.2 hereof) in the courts of any jurisdiction and irrevocably agrees, to the extent permitted by applicable law, that it will not claim any such immunity in any Proceedings.

IN WITNESS WHEREOF, the Parties have caused this Agreement to be duly executed by their respective authorized officers as of the date first written above.

____

By:______________________

Title:____________________

____

By:______________________

Title:____________________

EXHIBIT I

CURRENCY OPTION CONFIRMATION

To:____________________

________________________hereby confirms the following terms of a currency option:

Reference:

Trade Date (DD/MMM/YY):

Buyer:

Seller:

Option Style (European or American):

Option Type (Put or Call):

Put Currency and Amount:

Call Currency and Amount:

Strike Price:

Expiration Date (DD/MMM/YY):

Expiration Time:

Expiration Settlement Date (DD/MMM/YY):

Premium:

Price:

Premium Payment Date (DD/MMM/YY):

Premium Payment Instructions:

Other terms and conditions:

This Option is subject to the International Currency Options Market Master Agreement between [us] [_____________and __________, dated as of__________________ , 19___].

Please confirm to us by return telex, mail, facsimile or other electronic transmission that the above details are correct.

SCHEDULE

Part I: Designated Offices

Each of the following shall be a Designated Office:

Part II: Notices

Address

Telephone Number

Telex Number

Facsimile Number

Name of Individual or Department to Whom Notices Are to Be Sent

Part III: Payment Instructions

Name of Bank and Office, Account Number and Reference with Respect to Relevant Currencies

Part IV: Base Currency

Appendix II

3 International Swap Dealers Association (ISDA) Master Agreement

(Multicurrency—Cross Border)

ISDA®

International Swap Dealers Association, Inc.

MASTER AGREEMENT

dated as of ....

.... and ....

have entered and/or anticipate entering into one or more transactions (each a "Transaction") that are or will be governed by this Master Agreement, which includes the schedule (the "Schedule"), and the documents and other confirming evidence (each a "Confirmation") exchanged between the parties confirming those Transactions.

Accordingly, the parties agree as follows:—

1. Interpretation

(a) ***Definitions.*** The terms defined in Section 14 and in the Schedule will have the meanings therein specified for the purpose of this Master Agreement.

(b) ***Inconsistency.*** In the event of any inconsistency between the provisions of the Schedule and the other provisions of this Master Agreement, the Schedule will prevail. In the event of any inconsistency between the provisions of any Confirmation and this Master Agreement (including the Schedule), such Confirmation will prevail for the purpose of the relevant Transaction.

(c) ***Single Agreement.*** All Transactions are entered into in reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties (collectively referred to as this "Agreement"), and the parties would not otherwise enter into any Transactions.

2. Obligations

(a) ***General Conditions.***

(i) Each party will make each payment or delivery specified in each Confirmation to be made by it, subject to the other provisions of this Agreement.

(ii) Payments under this Agreement will be made on the due date for value on that date in the place of the account specified in the relevant Confirmation or otherwise pursuant to this Agreement, in freely transferable funds and in the manner customary for payments in the required currency. Where settlement is by delivery (that is, other than by payment), such delivery will be made for receipt on the due date in the manner customary for the relevant obligation unless otherwise specified in the relevant Confirmation or elsewhere in this Agreement.

(iii) Each obligation of each party under Section 2(a)(i) is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each other applicable condition precedent specified in this Agreement.

Copyright © 1992 by International Swap Dealers Association, Inc.

[1]This text is reproduced with permission from the International Swap Dealers Association, Inc.

(b) *Change of Account.* Either party may change its account for receiving a payment or delivery by giving notice to the other party at least five Local Business Days prior to the scheduled date for the payment or delivery to which such change applies unless such other party gives timely notice of a reasonable objection to such change.

(c) *Netting.* If on any date amounts would otherwise be payable:—

(i) in the same currency; and

(ii) in respect of the same Transaction,

by each party to the other, then, on such date, each party's obligation to make payment of any such amount will be automatically satisfied and discharged and, if the aggregate amount that would otherwise have been payable by one party exceeds the aggregate amount that would otherwise have been payable by the other party, replaced by an obligation upon the party by whom the larger aggregate amount would have been payable to pay to the other party the excess of the larger aggregate amount over the smaller aggregate amount.

The parties may elect in respect of two or more Transactions that a net amount will be determined in respect of all amounts payable on the same date in the same currency in respect of such Transactions, regardless of whether such amounts are payable in respect of the same Transaction. The election may be made in the Schedule or a Confirmation by specifying that subparagraph (ii) above will not apply to the Transactions identified as being subject to the election, together with the starting date (in which case subparagraph (ii) above will not, or will cease to, apply to such Transactions from such date). This election may be made separately for different groups of Transactions and will apply separately to each pairing of Offices through which the parties make and receive payments or deliveries.

(d) *Deduction or Withholding for Tax.*

(i) *Gross-Up.* All payments under this Agreement will be made without any deduction or withholding for or on account of any Tax unless such deduction or withholding is required by any applicable law, as modified by the practice of any relevant governmental revenue authority, then in effect. If a party is so required to deduct or withhold, then that party ("X") will:—

(1) promptly notify the other party ("Y") of such requirement;

(2) pay to the relevant authorities the full amount required to be deducted or withheld (including the full amount required to be deducted or withheld from any additional amount paid by X to Y under this Section 2(d)) promptly upon the earlier of determining that such deduction or withholding is required or receiving notice that such amount has been assessed against Y;

(3) promptly forward to Y an official receipt (or a certified copy), or other documentation reasonably acceptable to Y, evidencing such payment to such authorities; and

(4) if such Tax is an Indemnifiable Tax, pay to Y, in addition to the payment to which Y is otherwise entitled under this Agreement, such additional amount as is necessary to ensure that the net amount actually received by Y (free and clear of Indemnifiable Taxes, whether assessed against X or Y) will equal the full amount Y would have received had no such deduction or withholding been required. However, X will not be required to pay any additional amount to Y to the extent that it would not be required to be paid but for:—

(A) the failure by Y to comply with or perform any agreement contained in Section 4(a)(i), 4(a)(iii) or 4(d); or

(B) the failure of a representation made by Y pursuant to Section 3(f) to be accurate and true unless such failure would not have occurred but for (I) any action taken by a taxing authority, or brought in a court of competent jurisdiction, on or after the date on which a Transaction is entered into (regardless of whether such action is taken or brought with respect to a party to this Agreement) or (II) a Change in Tax Law.

(ii) ***Liability.*** If:—

(1) X is required by any applicable law, as modified by the practice of any relevant governmental revenue authority, to make any deduction or withholding in respect of which X would not be required to pay an additional amount to Y under Section 2(d)(i)(4);

(2) X does not so deduct or withhold; and

(3) a liability resulting from such Tax is assessed directly against X,

then, except to the extent Y has satisfied or then satisfies the liability resulting from such Tax, Y will promptly pay to X the amount of such liability (including any related liability for interest, but including any related liability for penalties only if Y has failed to comply with or perform any agreement contained in Section 4(a)(i), 4(a)(iii) or 4(d)).

(e) ***Default Interest; Other Amounts.*** Prior to the occurrence or effective designation of an Early Termination Date in respect of the relevant Transaction, a party that defaults in the performance of any payment obligation will, to the extent permitted by law and subject to Section 6(c), be required to pay interest (before as well as after judgment) on the overdue amount to the other party on demand in the same currency as such overdue amount, for the period from (and including) the original due date for payment to (but excluding) the date of actual payment, at the Default Rate. Such interest will be calculated on the basis of daily compounding and the actual number of days elapsed. If, prior to the occurrence or effective designation of an Early Termination Date in respect of the relevant Transaction, a party defaults in the performance of any obligation required to be settled by delivery, it will compensate the other party on demand if and to the extent provided for in the relevant Confirmation or elsewhere in this Agreement.

3. Representations

Each party represents to the other party (which representations will be deemed to be repeated by each party on each date on which a Transaction is entered into and, in the case of the representations in Section 3(f), at all times until the termination of this Agreement) that:—

(a) ***Basic Representations.***

(i) ***Status.*** It is duly organised and validly existing under the laws of the jurisdiction of its organisation or incorporation and, if relevant under such laws, in good standing;

(ii) ***Powers.*** It has the power to execute this Agreement and any other documentation relating to this Agreement to which it is a party, to deliver this Agreement and any other documentation relating to this Agreement that it is required by this Agreement to deliver and to perform its obligations under this Agreement and any obligations it has under any Credit Support Document to which it is a party and has taken all necessary action to authorise such execution, delivery and performance;

(iii) ***No Violation or Conflict.*** Such execution, delivery and performance do not violate or conflict with any law applicable to it, any provision of its constitutional documents, any order or judgment of any court or other agency of government applicable to it or any of its assets or any contractual restriction binding on or affecting it or any of its assets;

(iv) ***Consents.*** All governmental and other consents that are required to have been obtained by it with respect to this Agreement or any Credit Support Document to which it is a party have been obtained and are in full force and effect and all conditions of any such consents have been complied with; and

(v) ***Obligations Binding.*** Its obligations under this Agreement and any Credit Support Document to which it is a party constitute its legal, valid and binding obligations, enforceable in accordance with their respective terms (subject to applicable bankruptcy, reorganisation, insolvency, moratorium or similar laws affecting creditors' rights generally and subject, as to enforceability, to equitable principles of general application (regardless of whether enforcement is sought in a proceeding in equity or at law)).

(b) ***Absence of Certain Events.*** No Event of Default or Potential Event of Default or, to its knowledge, Termination Event with respect to it has occurred and is continuing and no such event or circumstance would occur as a result of its entering into or performing its obligations under this Agreement or any Credit Support Document to which it is a party.

(c) ***Absence of Litigation.*** There is not pending or, to its knowledge, threatened against it or any of its Affiliates any action, suit or proceeding at law or in equity or before any court, tribunal, governmental body, agency or official or any arbitrator that is likely to affect the legality, validity or enforceability against it of this Agreement or any Credit Support Document to which it is a party or its ability to perform its obligations under this Agreement or such Credit Support Document.

(d) ***Accuracy of Specified Information.*** All applicable information that is furnished in writing by or on behalf of it to the other party and is identified for the purpose of this Section 3(d) in the Schedule is, as of the date of the information, true, accurate and complete in every material respect.

(e) ***Payer Tax Representation.*** Each representation specified in the Schedule as being made by it for the purpose of this Section 3(e) is accurate and true.

(f) ***Payee Tax Representations.*** Each representation specified in the Schedule as being made by it for the purpose of this Section 3(f) is accurate and true.

4. Agreements

Each party agrees with the other that, so long as either party has or may have any obligation under this Agreement or under any Credit Support Document to which it is a party:—

(a) ***Furnish Specified Information.*** It will deliver to the other party or, in certain cases under subparagraph (iii) below, to such government or taxing authority as the other party reasonably directs:—

> (i) any forms, documents or certificates relating to taxation specified in the Schedule or any Confirmation;
>
> (ii) any other documents specified in the Schedule or any Confirmation; and
>
> (iii) upon reasonable demand by such other party, any form or document that may be required or reasonably requested in writing in order to allow such other party or its Credit Support Provider to make a payment under this Agreement or any applicable Credit Support Document without any deduction or withholding for or on account of any Tax or with such deduction or withholding at a reduced rate (so long as the completion, execution or submission of such form or document would not materially prejudice the legal or commercial position of the party in receipt of such demand), with any such form or document to be accurate and completed in a manner reasonably satisfactory to such other party and to be executed and to be delivered with any reasonably required certification,

in each case by the date specified in the Schedule or such Confirmation or, if none is specified, as soon as reasonably practicable.

(b) ***Maintain Authorisations.*** It will use all reasonable efforts to maintain in full force and effect all consents of any governmental or other authority that are required to be obtained by it with respect to this Agreement or any Credit Support Document to which it is a party and will use all reasonable efforts to obtain any that may become necessary in the future.

(c) ***Comply with Laws.*** It will comply in all material respects with all applicable laws and orders to which it may be subject if failure so to comply would materially impair its ability to perform its obligations under this Agreement or any Credit Support Document to which it is a party.

(d) ***Tax Agreement.*** It will give notice of any failure of a representation made by it under Section 3(f) to be accurate and true promptly upon learning of such failure.

(e) ***Payment of Stamp Tax.*** Subject to Section 11, it will pay any Stamp Tax levied or imposed upon it or in respect of its execution or performance of this Agreement by a jurisdiction in which it is incorporated,

organised, managed and controlled, or considered to have its seat, or in which a branch or office through which it is acting for the purpose of this Agreement is located ("Stamp Tax Jurisdiction") and will indemnify the other party against any Stamp Tax levied or imposed upon the other party or in respect of the other party's execution or performance of this Agreement by any such Stamp Tax Jurisdiction which is not also a Stamp Tax Jurisdiction with respect to the other party.

5. Events of Default and Termination Events

(a) ***Events of Default.*** The occurrence at any time with respect to a party or, if applicable, any Credit Support Provider of such party or any Specified Entity of such party of any of the following events constitutes an event of default (an "Event of Default") with respect to such party:—

(i) ***Failure to Pay or Deliver.*** Failure by the party to make, when due, any payment under this Agreement or delivery under Section 2(a)(i) or 2(e) required to be made by it if such failure is not remedied on or before the third Local Business Day after notice of such failure is given to the party;

(ii) ***Breach of Agreement.*** Failure by the party to comply with or perform any agreement or obligation (other than an obligation to make any payment under this Agreement or delivery under Section 2(a)(i) or 2(e) or to give notice of a Termination Event or any agreement or obligation under Section 4(a)(i), 4(a)(iii) or 4(d)) to be complied with or performed by the party in accordance with this Agreement if such failure is not remedied on or before the thirtieth day after notice of such failure is given to the party;

(iii) *Credit Support Default.*

(1) Failure by the party or any Credit Support Provider of such party to comply with or perform any agreement or obligation to be complied with or performed by it in accordance with any Credit Support Document if such failure is continuing after any applicable grace period bas elapsed;

(2) the expiration or termination of such Credit Support Document or the failing or ceasing of such Credit Support Document to be in full force and effect for the purpose of this Agreement (in either case other than in accordance with its terms) prior to the satisfaction of all obligations of such party under each Transaction to which such Credit Support Document relates without the written consent of the other party; or

(3) the party or such Credit Support Provider disaffirms, disclaims, repudiates or rejects, in whole or in part, or challenges the validity of, such Credit Support Document;

(iv) ***Misrepresentation.*** A representation (other than a representation under Section 3(e) or (f)) made or repeated or deemed to have been made or repeated by the party or any Credit Support Provider of such party in this Agreement or any Credit Support Document proves to have been incorrect or misleading in any material respect when made or repeated or deemed to have been made or repeated;

(v) ***Default under Specified Transaction.*** The party, any Credit Support Provider of such party or any applicable Specified Entity of such party (1) defaults under a Specified Transaction and, after giving effect to any applicable notice requirement or grace period, there occurs a liquidation of, an acceleration of obligations under, or an early termination of, that Specified Transaction, (2) defaults, after giving effect to any applicable notice requirement or grace period, in making any payment or delivery due on the last payment, delivery or exchange date of, or any payment on early termination of, a Specified Transaction (or such default continues for at least three Local Business Days if there is no applicable notice requirement or grace period) or (3) disaffirms, disclaims, repudiates or rejects, in whole or in part, a Specified Transaction (or such action is taken by any person or entity appointed or empowered to operate it or act on its behalf);

(vi) ***Cross Default.*** If "Cross Default" is specified in the Schedule as applying to the party, the occurrence or existence of (1) a default, event of default or other similar condition or event (however

described) in respect of such party, any Credit Support Provider of such party or any applicable Specified Entity of such party under one or more agreements or instruments relating to Specified Indebtedness of any of them (individually or collectively) in an aggregate amount of not less than the applicable Threshold Amount (as specified in the Schedule) which has resulted in such Specified Indebtedness becoming, or becoming capable at such time of being declared, due and payable under such agreements or instruments, before it would otherwise have been due and payable or (2) a default by such party, such Credit Support Provider or such Specified Entity (individually or collectively) in making one or more payments on the due date thereof in an aggregate amount of not less than the applicable Threshold Amount under such agreements or instruments (after giving effect to any applicable notice requirement or grace period);

(vii) ***Bankruptcy.*** The party, any Credit Support Provider of such party or any applicable Specified Entity of such party:—

(1) is dissolved (other than pursuant to a consolidation, amalgamation or merger); (2) becomes insolvent or is unable to pay its debts or fails or admits in writing its inability generally to pay its debts as they become due; (3) makes a general assignment, arrangement or composition with or for the benefit of its creditors; (4) institutes or has instituted against it a proceeding seeking a judgment of insolvency or bankruptcy or any other relief under any bankruptcy or insolvency law or other similar law affecting creditors' rights, or a petition is presented for its winding-up or liquidation, and, in the case of any such proceeding or petition instituted or presented against it, such proceeding or petition (A) results in a judgment of insolvency or bankruptcy or the entry of an order for relief or the making of an order for its winding-up or liquidation or (B) is not dismissed, discharged, stayed or restrained in each case within 30 days of the institution or presentation thereof; (5) has a resolution passed for its winding-up, official management or liquidation (other than pursuant to a consolidation, amalgamation or merger); (6) seeks or becomes subject to the appointment of an administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official for it or for all or substantially all its assets; (7) has a secured party take possession of all or substantially all its assets or has a distress, execution, attachment, sequestration or other legal process levied, enforced or sued on or against all or substantially all its assets and such secured party maintains possession, or any such process is not dismissed, discharged, stayed or restrained, in each case within 30 days thereafter; (8) causes or is subject to any event with respect to it which, under the applicable laws of any jurisdiction, has an analogous effect to any of the events specified in clauses (1) to (7) (inclusive); or (9) takes any action in furtherance of, or indicating its consent to, approval of, or acquiescence in, any of the foregoing acts; or

(viii) ***Merger Without Assumption.*** The party or any Credit Support Provider of such party consolidates or amalgamates with, or merges with or into, or transfers all or substantially all its assets to, another entity and, at the time of such consolidation, amalgamation, merger or transfer:—

(1) the resulting, surviving or transferee entity fails to assume all the obligations of such party or such Credit Support Provider under this Agreement or any Credit Support Document to which it or its predecessor was a party by operation of law or pursuant to an agreement reasonably satisfactory to the other party to this Agreement; or

(2) the benefits of any Credit Support Document fail to extend (without the consent of the other party) to the performance by such resulting, surviving or transferee entity of its obligations under this Agreement.

(b) ***Termination Events.*** The occurrence at any time with respect to a party or, if applicable, any Credit Support Provider of such party or any Specified Entity of such party of any event specified below constitutes an Illegality if the event is specified in (i) below, a Tax Event if the event is specified in (ii) below or a Tax Event Upon Merger if the event is specified in (iii) below, and, if specified to be applicable, a Credit Event

Upon Merger if the event is specified pursuant to (iv) below or an Additional Termination Event if the event is specified pursuant to (v) below:—

(i) ***Illegality.*** Due to the adoption of, or any change in, any applicable law after the date on which a Transaction is entered into, or due to the promulgation of, or any change in, the interpretation by any court, tribunal or regulatory authority with competent jurisdiction of any applicable law after such date, it becomes unlawful (other than as a result of a breach by the party of Section 4(b)) for such party (which will be the Affected Party):—

(1) to perform any absolute or contingent obligation to make a payment or delivery or to receive a payment or delivery in respect of such Transaction or to comply with any other material provision of this Agreement relating to such Transaction; or

(2) to perform, or for any Credit Support Provider of such party to perform, any contingent or other obligation which the party (or such Credit Support Provider) has under any Credit Support Document relating to such Transaction;

(ii) ***Tax Event.*** Due to (x) any action taken by a taxing authority, or brought in a court of competent jurisdiction, on or after the date on which a Transaction is entered into (regardless of whether such action is taken or brought with respect to a party to this Agreement) or (y) a Change in Tax Law, the party (which will be the Affected Party) will, or there is a substantial likelihood that it will, on the next succeeding Scheduled Payment Date (1) be required to pay to the other party an additional amount in respect of an Indemnifiable Tax under Section 2(d)(i)(4) (except in respect of interest under Section 2(e), 6(d)(ii) or 6(e)) or (2) receive a payment from which an amount is required to be deducted or withheld for or on account of a Tax (except in respect of interest under Section 2(e), 6(d)(ii) or 6(e)) and no additional amount is required to be paid in respect of such Tax under Section 2(d)(i)(4) (other than by reason of Section 2(d)(i)(4)(A) or (B));

(iii) ***Tax Event Upon Merger.*** The party (the "Burdened Party") on the next succeeding Scheduled Payment Date will either (1) be required to pay an additional amount in respect of an Indemnifiable Tax under Section 2(d)(i)(4) (except in respect of interest under Section 2(e), 6(d)(ii) or 6(e)) or (2) receive a payment from which an amount has been deducted or withheld for or on account of any Indemnifiable Tax in respect of which the other party is not required to pay an additional amount (other than by reason of Section 2(d)(i)(4)(A) or (B)), in either case as a result of a party consolidating or amalgamating with, or merging with or into, or transferring all or substantially all its assets to, another entity (which will be the Affected Party) where such action does not constitute an event described in Section 5(a)(viii);

(iv) ***Credit Event Upon Merger.*** If "Credit Event Upon Merger" is specified in the Schedule as applying to the party, such party ("X"), any Credit Support Provider of X or any applicable Specified Entity of X consolidates or amalgamates with, or merges with or into, or transfers all or substantially all its assets to, another entity and such action does not constitute an event described in Section 5(a)(viii) but the creditworthiness of the resulting, surviving or transferee entity is materially weaker than that of X, such Credit Support Provider or such Specified Entity, as the case may be, immediately prior to such action (and, in such event, X or its successor or transferee, as appropriate, will be the Affected Party); or

(v) ***Additional Termination Event.*** If any "Additional Termination Event" is specified in the Schedule or any Confirmation as applying, the occurrence of such event (and, in such event, the Affected Party or Affected Parties shall be as specified for such Additional Termination Event in the Schedule or such Confirmation).

(c) ***Event of Default and Illegality.*** If an event or circumstance which would otherwise constitute or give rise to an Event of Default also constitutes an Illegality, it will be treated as an Illegality and will not constitute an Event of Default.

6. Early Termination

(a) ***Right to Terminate Following Event of Default.*** If at any time an Event of Default with respect to a party (the "Defaulting Party") has occurred and is then continuing, the other party (the "Non-defaulting Party") may, by not more than 20 days notice to the Defaulting Party specifying the relevant Event of Default, designate a day not earlier than the day such notice is effective as an Early Termination Date in respect of all outstanding Transactions. If, however, "Automatic Early Termination" is specified in the Schedule as applying to a party, then an Early Termination Date in respect of all outstanding Transactions will occur immediately upon the occurrence with respect to such party of an Event of Default specified in Section 5(a)(vii)(1), (3), (5), (6) or, to the extent analogous thereto, (8), and as of the time immediately preceding the institution of the relevant proceeding or the presentation of the relevant petition upon the occurrence with respect to such party of an Event of Default specified in Section 5(a)(vii)(4) or, to the extent analogous thereto, (8).

(b) ***Right to Terminate Following Termination Event.***

(i) ***Notice.*** If a Termination Event occurs, an Affected Party will, promptly upon becoming aware of it, notify the other party, specifying the nature of that Termination Event and each Affected Transaction and will also give such other information about that Termination Event as the other party may reasonably require.

(ii) ***Transfer to Avoid Termination Event.*** If either an Illegality under Section 5(b)(i)(1) or a Tax Event occurs and there is only one Affected Party, or if a Tax Event Upon Merger occurs and the Burdened Party is the Affected Party, the Affected Party will, as a condition to its right to designate an Early Termination Date under Section 6(b)(iv), use all reasonable efforts (which will not require such party to incur a loss, excluding immaterial, incidental expenses) to transfer within 20 days after it gives notice under Section 6(b)(i) all its rights and obligations under this Agreement in respect of the Affected Transactions to another of its Offices or Affiliates so that such Termination Event ceases to exist.

If the Affected Party is not able to make such a transfer it will give notice to the other party to that effect within such 20 day period, whereupon the other party may effect such a transfer within 30 days after the notice is given under Section 6(b)(i).

Any such transfer by a party under this Section 6(b)(ii) will be subject to and conditional upon the prior written consent of the other party, which consent will not be withheld if such other party's policies in effect at such time would permit it to enter into transactions with the transferee on the terms proposed.

(iii) ***Two Affected Parties.*** If an Illegality under Section 5(b)(i)(1) or a Tax Event occurs and there are two Affected Parties, each party will use all reasonable efforts to reach agreement within 30 days after notice thereof is given under Section 6(b)(i) on action to avoid that Termination Event.

(iv) ***Right to Terminate.*** If:—

(1) a transfer under Section 6(b)(ii) or an agreement under Section 6(b)(iii), as the case may be, has not been effected with respect to all Affected Transactions within 30 days after an Affected Party gives notice under Section 6(b)(i); or

(2) an Illegality under Section 5(b)(i)(2), a Credit Event Upon Merger or an Additional Termination Event occurs, or a Tax Event Upon Merger occurs and the Burdened Party is not the Affected Party,

either party in the case of an Illegality, the Burdened Party in the case of a Tax Event Upon Merger, any Affected Party in the case of a Tax Event or an Additional Termination Event if there is more than one Affected Party, or the party which is not the Affected Party in the case of a Credit Event Upon Merger or an Additional Termination Event if there is only one Affected Party may, by not more than 20 days notice to the other party and provided that the relevant Termination Event is then

continuing, designate a day not earlier than the day such notice is effective as an Early Termination Date in respect of all Affected Transactions.

(c) *Effect of Designation.*

(i) If notice designating an Early Termination Date is given under Section 6(a) or (b), the Early Termination Date will occur on the date so designated, whether or not the relevant Event of Default or Termination Event is then continuing.

(ii) Upon the occurrence or effective designation of an Early Termination Date, no further payments or deliveries under Section 2(a)(i) or 2(e) in respect of the Terminated Transactions will be required to be made, but without prejudice to the other provisions of this Agreement. The amount, if any, payable in respect of an Early Termination Date shall be determined pursuant to Section 6(e).

(d) *Calculations.*

(i) *Statement.* On or as soon as reasonably practicable following the occurrence of an Early Termination Date, each party will make the calculations on its part, if any, contemplated by Section 6(e) and will provide to the other party a statement (1) showing, in reasonable detail, such calculations (including all relevant quotations and specifying any amount payable under Section 6(e)) and (2) giving details of the relevant account to which any amount payable to it is to be paid. In the absence of written confirmation from the source of a quotation obtained in determining a Market Quotation, the records of the party obtaining such quotation will be conclusive evidence of the existence and accuracy of such quotation.

(ii) *Payment Date.* An amount calculated as being due in respect of any Early Termination Date under Section 6(e) will be payable on the day that notice of the amount payable is effective (in the case of an Early Termination Date which is designated or occurs as a result of an Event of Default) and on the day which is two Local Business Days after the day on which notice of the amount payable is effective (in the case of an Early Termination Date which is designated as a result of a Termination Event). Such amount will be paid together with (to the extent permitted under applicable law) interest thereon (before as well as after judgment) in the Termination Currency, from (and including) the relevant Early Termination Date to (but excluding) the date such amount is paid, at the Applicable Rate. Such interest will be calculated on the basis of daily compounding and the actual number of days elapsed.

(e) *Payments on Early Termination.* If an Early Termination Date occurs, the following provisions shall apply based on the parties' election in the Schedule of a payment measure, either "Market Quotation" or "Loss", and a payment method, either the "First Method" or the "Second Method". If the parties fail to designate a payment measure or payment method in the Schedule, it will be deemed that "Market Quotation" or the "Second Method", as the case may be, shall apply. The amount, if any, payable in respect of an Early Termination Date and determined pursuant to this Section will be subject to any Set-off.

(i) *Events of Default.* If the Early Termination Date results from an Event of Default:—

(1) *First Method and Market Quotation.* If the First Method and Market Quotation apply, the Defaulting Party will pay to the Non-defaulting Party the excess, if a positive number, of (A) the sum of the Settlement Amount (determined by the Non-defaulting Party) in respect of the Terminated Transactions and the Termination Currency Equivalent of the Unpaid Amounts owing to the Non-defaulting Party over (B) the Termination Currency Equivalent of the Unpaid Amounts owing to the Defaulting Party.

(2) *First Method and Loss.* If the First Method and Loss apply, the Defaulting Party will pay to the Non-defaulting Party, if a positive number, the Non-defaulting Party's Loss in respect of this Agreement.

(3) *Second Method and Market Quotation.* If the Second Method and Market Quotation apply, an amount will be payable equal to (A) the sum of the Settlement Amount (determined by the

Non-defaulting Party) in respect of the Terminated Transactions and the Termination Currency Equivalent of the Unpaid Amounts owing to the Non-defaulting Party less (B) the Termination Currency Equivalent of the Unpaid Amounts owing to the Defaulting Party. If that amount is a positive number, the Defaulting Party will pay it to the Non-defaulting Party; if it is a negative number, the Non-defaulting Party will pay the absolute value of that amount to the Defaulting Party.

(4) *Second Method and Loss.* If the Second Method and Loss apply, an amount will be payable equal to the Non-defaulting Party's Loss in respect of this Agreement. If that amount is a positive number, the Defaulting Party will pay it to the Non-defaulting Party; if it is a negative number, the Non-defaulting Party will pay the absolute value of that amount to the Defaulting Party.

(ii) ***Termination Events.*** If the Early Termination Date results from a Termination Event:—

(1) *One Affected Party.* If there is one Affected Party, the amount payable will be determined in accordance with Section 6(e)(i)(3), if Market Quotation applies, or Section 6(e)(i)(4), if Loss applies, except that, in either case, references to the Defaulting Party and to the Non-defaulting Party will be deemed to be references to the Affected Party and the party which is not the Affected Party, respectively, and, if Loss applies and fewer than all the Transactions are being terminated, Loss shall be calculated in respect of all Terminated Transactions.

(2) *Two Affected Parties.* If there are two Affected Parties:—

(A) if Market Quotation applies, each party will determine a Settlement Amount in respect of the Terminated Transactions, and an amount will be payable equal to (I) the sum of (a) one-half of the difference between the Settlement Amount of the party with the higher Settlement Amount ("X") and the Settlement Amount of the party with the lower Settlement Amount ("Y") and (b) the Termination Currency Equivalent of the Unpaid Amounts owing to X less (II) the Termination Currency Equivalent of the Unpaid Amounts owing to Y; and

(B) if Loss applies, each party will determine its Loss in respect of this Agreement (or, if fewer than all the Transactions are being terminated, in respect of all Terminated Transactions) and an amount will be payable equal to one-half of the difference between the Loss of the party with the higher Loss ("X") and the Loss of the party with the lower Loss ("Y").

If the amount payable is a positive number, Y will pay it to X; if it is a negative number, X will pay the absolute value of that amount to Y.

(iii) ***Adjustment for Bankruptcy.*** In circumstances where an Early Termination Date occurs because "Automatic Early Termination" applies in respect of a party, the amount determined under this Section 6(e) will be subject to such adjustments as are appropriate and permitted by law to reflect any payments or deliveries made by one party to the other under this Agreement (and retained by such other party) during the period from the relevant Early Termination Date to the date for payment determined under Section 6(d)(ii).

(iv) ***Pre-Estimate.*** The parties agree that if Market Quotation applies an amount recoverable under this Section 6(e) is a reasonable pre-estimate of loss and not a penalty. Such amount is payable for the loss of bargain and the loss of protection against future risks and except as otherwise provided in this Agreement neither party will be entitled to recover any additional damages as a consequence of such losses.

7. Transfer

Subject to Section 6(b)(ii), neither this Agreement nor any interest or obligation in or under this Agreement may be transferred (whether by way of security or otherwise) by either party without the prior written consent of the other party, except that:—

(a) a party may make such a transfer of this Agreement pursuant to a consolidation or amalgamation with, or merger with or into, or transfer of all or substantially all its assets to, another entity (but without prejudice to any other right or remedy under this Agreement); and

(b) a party may make such a transfer of all or any part of its interest in any amount payable to it from a Defaulting Party under Section 6(e).

Any purported transfer that is not in compliance with this Section will be void.

8. Contractual Currency

(a) ***Payment in the Contractual Currency.*** Each payment under this Agreement will be made in the relevant currency specified in this Agreement for that payment (the "Contractual Currency"). To the extent permitted by applicable law, any obligation to make payments under this Agreement in the Contractual Currency will not be discharged or satisfied by any tender in any currency other than the Contractual Currency, except to the extent such tender results in the actual receipt by the party to which payment is owed, acting in a reasonable manner and in good faith in converting the currency so tendered into the Contractual Currency, of the full amount in the Contractual Currency of all amounts payable in respect of this Agreement. If for any reason the amount in the Contractual Currency so received falls short of the amount in the Contractual Currency payable in respect of this Agreement, the party required to make the payment will, to the extent permitted by applicable law, immediately pay such additional amount in the Contractual Currency as may be necessary to compensate for the shortfall. If for any reason the amount in the Contractual Currency so received exceeds the amount in the Contractual Currency payable in respect of this Agreement, the party receiving the payment will refund promptly the amount of such excess.

(b) ***Judgments.*** To the extent permitted by applicable law, if any judgment or order expressed in a currency other than the Contractual Currency is rendered (i) for the payment of any amount owing in respect of this Agreement, (ii) for the payment of any amount relating to any early termination in respect of this Agreement or (iii) in respect of a judgment or order of another court for the payment of any amount described in (i) or (ii) above, the party seeking recovery, after recovery in full of the aggregate amount to which such party is entitled pursuant to the judgment or order, will be entitled to receive immediately from the other party the amount of any shortfall of the Contractual Currency received by such party as a consequence of sums paid in such other currency and will refund promptly to the other party any excess of the Contractual Currency received by such party as a consequence of sums paid in such other currency if such shortfall or such excess arises or results from any variation between the rate of exchange at which the Contractual Currency is converted into the currency of the judgment or order for the purposes of such judgment or order and the rate of exchange at which such party is able, acting in a reasonable manner and in good faith in converting the currency received into the Contractual Currency, to purchase the Contractual Currency with the amount of the currency of the judgment or order actually received by such party. The term "rate of exchange" includes, without limitation, any premiums and costs of exchange payable in connection with the purchase of or conversion into the Contractual Currency.

(c) ***Separate Indemnities.*** To the extent permitted by applicable law, these indemnities constitute separate and independent obligations from the other obligations in this Agreement, will be enforceable as separate and independent causes of action, will apply notwithstanding any indulgence granted by the party to which any payment is owed and will not be affected by judgment being obtained or claim or proof being made for any other sums payable in respect of this Agreement.

(d) ***Evidence of Loss.*** For the purpose of this Section 8, it will be sufficient for a party to demonstrate that it would have suffered a loss had an actual exchange or purchase been made.

9. Miscellaneous

(a) ***Entire Agreement.*** This Agreement constitutes the entire agreement and understanding of the parties with respect to its subject matter and supersedes all oral communication and prior writings with respect thereto.

(b) ***Amendments.*** No amendment, modification or waiver in respect of this Agreement will be effective unless in writing (including a writing evidenced by a facsimile transmission) and executed by each of the parties or confirmed by an exchange of telexes or electronic messages on an electronic messaging system.

(c) ***Survival of Obligations.*** Without prejudice to Sections 2(a)(iii) and 6(c)(ii), the obligations of the parties under this Agreement will survive the termination of any Transaction.

(d) ***Remedies Cumulative.*** Except as provided in this Agreement, the rights, powers, remedies and privileges provided in this Agreement are cumulative and not exclusive of any rights, powers, remedies and privileges provided by law.

(e) ***Counterparts and Confirmations.***

(i) This Agreement (and each amendment, modification and waiver in respect of it) may be executed and delivered in counterparts (including by facsimile transmission), each of which will be deemed an original.

(ii) The parties intend that they are legally bound by the terms of each Transaction from the moment they agree to those terms (whether orally or otherwise). A Confirmation shall be entered into as soon as practicable and may be executed and delivered in counterparts (including by facsimile transmission) or be created by an exchange of telexes or by an exchange of electronic messages on an electronic messaging system, which in each case will be sufficient for all purposes to evidence a binding supplement to this Agreement. The parties will specify therein or through another effective means that any such counterpart, telex or electronic message constitutes a Confirmation.

(f) ***No Waiver of Rights.*** A failure or delay in exercising any right, power or privilege in respect of this Agreement will not be presumed to operate as a waiver, and a single or partial exercise of any right, power or privilege will not be presumed to preclude any subsequent or further exercise, of that right, power or privilege or the exercise of any other right, power or privilege.

(g) ***Headings.*** The headings used in this Agreement are for convenience of reference only and are not to affect the construction of or to be taken into consideration in interpreting this Agreement.

10. Offices; Multibranch Parties

(a) If Section 10(a) is specified in the Schedule as applying, each party that enters into a Transaction through an Office other than its head or home office represents to the other party that, notwithstanding the place of booking office or jurisdiction of incorporation or organisation of such party, the obligations of such party are the same as if it had entered into the Transaction through its head or home office. This representation will be deemed to be repeated by such party on each date on which a Transaction is entered into.

(b) Neither party may change the Office through which it makes and receives payments or deliveries for the purpose of a Transaction without the prior written consent of the other party.

(c) If a party is specified as a Multibranch Party in the Schedule, such Multibranch Party may make and receive payments or deliveries under any Transaction through any Office listed in the Schedule, and the Office through which it makes and receives payments or deliveries with respect to a Transaction will be specified in the relevant Confirmation.

11. Expenses

A Defaulting Party will, on demand, indemnify and hold harmless the other party for and against all reasonable out-of-pocket expenses, including legal fees and Stamp Tax, incurred by such other party by reason of the enforcement and protection of its rights under this Agreement or any Credit Support Document

to which the Defaulting Party is a party or by reason of the early termination of any Transaction, including, but not limited to, costs of collection.

12. Notices

(a) ***Effectiveness.*** Any notice or other communication in respect of this Agreement may be given in any manner set forth below (except that a notice or other communication under Section 5 or 6 may not be given by facsimile transmission or electronic messaging system) to the address or number or in accordance with the electronic messaging system details provided (see the Schedule) and will be deemed effective as indicated:—

(i) if in writing and delivered in person or by courier, on the date it is delivered;

(ii) if sent by telex, on the date the recipient's answerback is received;

(iii) if sent by facsimile transmission, on the date that transmission is received by a responsible employee of the recipient in legible form (it being agreed that the burden of proving receipt will be on the sender and will not be met by a transmission report generated by the sender's facsimile machine);

(iv) if sent by certified or registered mail (airmail, if overseas) or the equivalent (return receipt requested), on the date that mail is delivered or its delivery is attempted; or

(v) if sent by electronic messaging system, on the date that electronic message is received,

unless the date of that delivery (or attempted delivery) or that receipt, as applicable, is not a Local Business Day or that communication is delivered (or attempted) or received, as applicable, after the close of business on a Local Business Day, in which case that communication shall be deemed given and effective on the first following day that is a Local Business Day.

(b) ***Change of Addresses.*** Either party may by notice to the other change the address, telex or facsimile number or electronic messaging system details at which notices or other communications are to be given to it.

13. Governing Law and Jurisdiction

(a) ***Governing Law.*** This Agreement will be governed by and construed in accordance with the law specified in the Schedule.

(b) ***Jurisdiction.*** With respect to any suit, action or proceedings relating to this Agreement ("Proceedings"), each party irrevocably:—

(i) submits to the jurisdiction of the English courts, if this Agreement is expressed to be governed by English law, or to the non-exclusive jurisdiction of the courts of the State of New York and the United States District Court located in the Borough of Manhattan in New York City, if this Agreement is expressed to be governed by the laws of the State of New York; and

(ii) waives any objection which it may have at any time to the laying of venue of any Proceedings brought in any such court, waives any claim that such Proceedings have been brought in an inconvenient forum and further waives the right to object, with respect to such Proceedings, that such court does not have any jurisdiction over such party.

Nothing in this Agreement precludes either party from bringing Proceedings in any other jurisdiction (outside, if this Agreement is expressed to be governed by English law, the Contracting States, as defined in Section 1(3) of the Civil Jurisdiction and Judgments Act 1982 or any modification, extension or re-enactment thereof for the time being in force) nor will the bringing of Proceedings in any one or more jurisdictions preclude the bringing of Proceedings in any other jurisdiction.

(c) ***Service of Process.*** Each party irrevocably appoints the Process Agent (if any) specified opposite its name in the Schedule to receive, for it and on its behalf, service of process in any Proceedings. If for any

reason any party's Process Agent is unable to act as such, such party will promptly notify the other party and within 30 days appoint a substitute process agent acceptable to the other party. The parties irrevocably consent to service of process given in the manner provided for notices in Section 12. Nothing in this Agreement will affect the right of either party to serve process in any other manner permitted by law.

(d) *Waiver of Immunities.* Each party irrevocably waives, to the fullest extent permitted by applicable law, with respect to itself and its revenues and assets (irrespective of their use or intended use), all immunity on the grounds of sovereignty or other similar grounds from (i) suit, (ii) jurisdiction of any court, (iii) relief by way of injunction, order for specific performance or for recovery of property, (iv) attachment of its assets (whether before or after judgment) and (v) execution or enforcement of any judgment to which it or its revenues or assets might otherwise be entitled in any Proceedings in the courts of any jurisdiction and irrevocably agrees, to the extent permitted by applicable law, that it will not claim any such immunity in any Proceedings.

14. Definitions

As used in this Agreement:—

"*Additional Termination Event*" has the meaning specified in Section 5(b).

"*Affected Party*" has the meaning specified in Section 5(b).

"*Affected Transactions*" means (a) with respect to any Termination Event consisting of an Illegality, Tax Event or Tax Event Upon Merger, all Transactions affected by the occurrence of such Termination Event and (b) with respect to any other Termination Event, all Transactions.

"*Affiliate*" means, subject to the Schedule, in relation to any person, any entity controlled, directly or indirectly, by the person, any entity that controls, directly or indirectly, the person or any entity directly or indirectly under common control with the person. For this purpose, "control" of any entity or person means ownership of a majority of the voting power of the entity or person.

"*Applicable Rate*" means:—

(a) in respect of obligations payable or deliverable (or which would have been but for Section 2(a)(iii)) by a Defaulting Party, the Default Rate;

(b) in respect of an obligation to pay an amount under Section 6(e) of either party from and after the date (determined in accordance with Section 6(d)(ii)) on which that amount is payable, the Default Rate;

(c) in respect of all other obligations payable or deliverable (or which would have been but for Section 2(a)(iii)) by a Non-defaulting Party, the Non-default Rate; and

(d) in all other cases, the Termination Rate.

"*Burdened Party*" has the meaning specified in Section 5(b).

"*Change in Tax Law*" means the enactment, promulgation, execution or ratification of, or any change in or amendment to, any law (or in the application or official interpretation of any law) that occurs on or after the date on which the relevant Transaction is entered into.

"*consent*" includes a consent, approval, action, authorisation, exemption, notice, filing, registration or exchange control consent.

"*Credit Event Upon Merger*" has the meaning specified in Section 5(b).

"*Credit Support Document*" means any agreement or instrument that is specified as such in this Agreement.

"*Credit Support Provider*" has the meaning specified in the Schedule.

"*Default Rate*" means a rate per annum equal to the cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount plus 1% per annum.

"Defaulting Party" has the meaning specified in Section 6(a).

"Early Termination Date" means the date determined in accordance with Section 6(a) or 6(b)(iv).

"Event of Default" has the meaning specified in Section 5(a) and, if applicable, in the Schedule.

"Illegality" has the meaning specified in Section 5(b).

"Indemnifiable Tax" means any Tax other than a Tax that would not be imposed in respect of a payment under this Agreement but for a present or former connection between the jurisdiction of the government or taxation authority imposing such Tax and the recipient of such payment or a person related to such recipient (including, without limitation, a connection arising from such recipient or related person being or having been a citizen or resident of such jurisdiction, or being or having been organised, present or engaged in a trade or business in such jurisdiction, or having or having had a permanent establishment or fixed place of business in such jurisdiction, but excluding a connection arising solely from such recipient or related person having executed, delivered, performed its obligations or received a payment under, or enforced, this Agreement or a Credit Support Document).

"law" includes any treaty, law, rule or regulation (as modified, in the case of tax matters, by the practice of any relevant governmental revenue authority) and ***"lawful"*** and ***"unlawful"*** will be construed accordingly.

"Local Business Day" means, subject to the Schedule, a day on which commercial banks are open for business (including dealings in foreign exchange and foreign currency deposits) (a) in relation to any obligation under Section 2(a)(i), in the place(s) specified in the relevant Confirmation or, if not so specified, as otherwise agreed by the parties in writing or determined pursuant to provisions contained, or incorporated by reference, in this Agreement, (b) in relation to any other payment, in the place where the relevant account is located and, if different, in the principal financial centre, if any, of the currency of such payment, (c) in relation to any notice or other communication, including notice contemplated under Section 5(a)(i), in the city specified in the address for notice provided by the recipient and, in the case of a notice contemplated by Section 2(b), in the place where the relevant new account is to be located and (d) in relation to Section 5(a)(v)(2), in the relevant locations for performance with respect to such Specified Transaction.

"Loss" means, with respect to this Agreement or one or more Terminated Transactions, as the case may be, and a party, the Termination Currency Equivalent of an amount that party reasonably determines in good faith to be its total losses and costs (or gain, in which case expressed as a negative number) in connection with this Agreement or that Terminated Transaction or group of Terminated Transactions, as the case may be, including any loss of bargain, cost of funding or, at the election of such party but without duplication, loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing any hedge or related trading position (or any gain resulting from any of them). Loss includes losses and costs (or gains) in respect of any payment or delivery required to have been made (assuming satisfaction of each applicable condition precedent) on or before the relevant Early Termination Date and not made, except, so as to avoid duplication, if Section 6(e)(i)(1) or (3) or 6(e)(ii)(2)(A) applies. Loss does not include a party's legal fees and out-of-pocket expenses referred to under Section 11. A party will determine its Loss as of the relevant Early Termination Date, or, if that is not reasonably practicable, as of the earliest date thereafter as is reasonably practicable. A party may (but need not) determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets.

"Market Quotation" means, with respect to one or more Terminated Transactions and a party making the determination, an amount determined on the basis of quotations from Reference Market-makers. Each quotation will be for an amount, if any, that would be paid to such party (expressed as a negative number) or by such party (expressed as a positive number) in consideration of an agreement between such party (taking into account any existing Credit Support Document with respect to the obligations of such party) and the quoting Reference Market-maker to enter into a transaction (the "Replacement Transaction") that would have the effect of preserving for such party the economic equivalent of any payment or delivery (whether the underlying obligation was absolute or contingent and assuming the satisfaction of each applicable condition precedent) by the parties under Section 2(a)(i) in respect of such Terminated Transaction or group of Terminated Transactions that would, but for the occurrence of the relevant Early Termination Date, have

been required after that date. For this purpose, Unpaid Amounts in respect of the Terminated Transaction or group of Terminated Transactions are to be excluded but, without limitation, any payment or delivery that would, but for the relevant Early Termination Date, have been required (assuming satisfaction of each applicable condition precedent) after that Early Termination Date is to be included. The Replacement Transaction would be subject to such documentation as such party and the Reference Market-maker may, in good faith, agree. The party making the determination (or its agent) will request each Reference Market-maker to provide its quotation to the extent reasonably practicable as of the same day and time (without regard to different time zones) on or as soon as reasonably practicable after the relevant Early Termination Date. The day and time as of which those quotations are to be obtained will be selected in good faith by the party obliged to make a determination under Section 6(e), and, if each party is so obliged, after consultation with the other. If more than three quotations are provided, the Market Quotation will be the arithmetic mean of the quotations, without regard to the quotations having the highest and lowest values. If exactly three such quotations are provided, the Market Quotation will be the quotation remaining after disregarding the highest and lowest quotations. For this purpose, if more than one quotation has the same highest value or lowest value, then one of such quotations shall be disregarded. If fewer than three quotations are provided, it will be deemed that the Market Quotation in respect of such Terminated Transaction or group of Terminated Transactions cannot be determined.

"***Non-default Rate***" means a rate per annum equal to the cost (without proof or evidence of any actual cost) to the Non-defaulting Party (as certified by it) if it were to fund the relevant amount.

"***Non-defaulting Party***" has the meaning specified in Section 6(a).

"***Office***" means a branch or office of a party, which may be such party's head or home office.

"***Potential Event of Default***" means any event which, with the giving of notice or the lapse of time or both, would constitute an Event of Default.

"***Reference Market-makers***" means four leading dealers in the relevant market selected by the party determining a Market Quotation in good faith (a) from among dealers of the highest credit standing which satisfy all the criteria that such party applies generally at the time in deciding whether to offer or to make an extension of credit and (b) to the extent practicable, from among such dealers having an office in the same city.

"***Relevant Jurisdiction***" means, with respect to a party, the jurisdictions (a) in which the party is incorporated, organised, managed and controlled or considered to have its seat, (b) where an Office through which the party is acting for purposes of this Agreement is located, (c) in which the party executes this Agreement and (d) in relation to any payment, from or through which such payment is made.

"***Scheduled Payment Date***" means a date on which a payment or delivery is to be made under Section 2(a)(i) with respect to a Transaction.

"***Set-off***" means set-off, offset, combination of accounts, right of retention or withholding or similar right or requirement to which the payer of an amount under Section 6 is entitled or subject (whether arising under this Agreement, another contract, applicable law or otherwise) that is exercised by, or imposed on, such payer.

"***Settlement Amount***" means, with respect to a party and any Early Termination Date, the sum of:—

(a) the Termination Currency Equivalent of the Market Quotations (whether positive or negative) for each Terminated Transaction or group of Terminated Transactions for which a Market Quotation is determined; and

(b) such party's Loss (whether positive or negative and without reference to any Unpaid Amounts) for each Terminated Transaction or group of Terminated Transactions for which a Market Quotation cannot be determined or would not (in the reasonable belief of the party making the determination) produce a commercially reasonable result.

"***Specified Entity***" has the meaning specified in the Schedule.

"*Specified Indebtedness*" means, subject to the Schedule, any obligation (whether present or future, contingent or otherwise, as principal or surety or otherwise) in respect of borrowed money.

"*Specified Transaction*" means, subject to the Schedule, (a) any transaction (including an agreement with respect thereto) now existing or hereafter entered into between one party to this Agreement (or any Credit Support Provider of such party or any applicable Specified Entity of such party) and the other party to this Agreement (or any Credit Support Provider of such other party or any applicable Specified Entity of such other party) which is a rate swap transaction, basis swap, forward rate transaction, commodity swap, commodity option, equity or equity index swap, equity or equity index option, bond option, interest rate option, foreign exchange transaction, cap transaction, floor transaction, collar transaction, currency swap transaction, cross-currency rate swap transaction, currency option or any other similar transaction (including any option with respect to any of these transactions), (b) any combination of these transactions and (c) any other transaction identified as a Specified Transaction in this Agreement or the relevant confirmation.

"*Stamp Tax*" means any stamp, registration, documentation or similar tax.

"*Tax*" means any present or future tax, levy, impost, duty, charge, assessment or fee of any nature (including interest, penalties and additions thereto) that is imposed by any government or other taxing authority in respect of any payment under this Agreement other than a stamp, registration, documentation or similar tax.

"*Tax Event*" has the meaning specified in Section 5(b).

"*Tax Event Upon Merger*" has the meaning specified in Section 5(b).

"*Terminated Transactions*" means with respect to any Early Termination Date (a) if resulting from a Termination Event, all Affected Transactions and (b) if resulting from an Event of Default, all Transactions (in either case) in effect immediately before the effectiveness of the notice designating that Early Termination Date (or, if "Automatic Early Termination" applies, immediately before that Early Termination Date).

"*Termination Currency*" has the meaning specified in the Schedule.

"*Termination Currency Equivalent*" means, in respect of any amount denominated in the Termination Currency, such Termination Currency amount and, in respect of any amount denominated in a currency other than the Termination Currency (the "Other Currency"), the amount in the Termination Currency determined by the party making the relevant determination as being required to purchase such amount of such Other Currency as at the relevant Early Termination Date, or, if the relevant Market Quotation or Loss (as the case may be), is determined as of a later date, that later date, with the Termination Currency at the rate equal to the spot exchange rate of the foreign exchange agent (selected as provided below) for the purchase of such Other Currency with the Termination Currency at or about 11:00 a.m. (in the city in which such foreign exchange agent is located) on such date as would be customary for the determination of such a rate for the purchase of such Other Currency for value on the relevant Early Termination Date or that later date. The foreign exchange agent will, if only one party is obliged to make a determination under Section 6(e), be selected in good faith by that party and otherwise will be agreed by the parties.

"*Termination Event*" means an Illegality, a Tax Event or a Tax Event Upon Merger or, if specified to be applicable, a Credit Event Upon Merger or an Additional Termination Event.

"*Termination Rate*" means a rate per annum equal to the arithmetic mean of the cost (without proof or evidence of any actual cost) to each party (as certified by such party) if it were to fund or of funding such amounts.

"*Unpaid Amounts*" owing to any party means, with respect to an Early Termination Date, the aggregate of (a) in respect of all Terminated Transactions, the amounts that became payable (or that would have become payable but for Section 2(a)(iii)) to such party under Section 2(a)(i) on or prior to such Early Termination Date and which remain unpaid as at such Early Termination Date and (b) in respect of each Terminated Transaction, for each obligation under Section 2(a)(i) which was (or would have been but for Section 2(a)(iii)) required to be settled by delivery to such party on or prior to such Early Termination Date and which has not been so settled as at such Early Termination Date, an amount equal to the fair market

value of that which was (or would have been) required to be delivered as of the originally scheduled date for delivery, in each case together with (to the extent permitted under applicable law) interest, in the currency of such amounts, from (and including) the date such amounts or obligations were or would have been required to have been paid or performed to (but excluding) such Early Termination Date, at the Applicable Rate. Such amounts of interest will be calculated on the basis of daily compounding and the actual number of days elapsed. The fair market value of any obligation referred to in clause (b) above shall be reasonably determined by the party obliged to make the determination under Section 6(e) or, if each party is so obliged, it shall be the average of the Termination Currency Equivalents of the fair market values reasonably determined by both parties.

IN WITNESS WHEREOF the parties have executed this document on the respective dates specified below with effect from the date specified on the first page of this document.

....	....
(Name of Party)	(Name of Party)
By:	By: ....
Name:	Name:
Title:	Title:
Date:	Date:

(Multicurrency—Cross Border)

ISDA®

International Swap Dealers Association, Inc.

SCHEDULE
to the
Master Agreement

dated as of ....

between .... and ....
("Party A") ("Party B")

Part 1. **Termination Provisions.**

(a) *"Specified Entity"* means in relation to Party A for the purpose of:—

Section 5(a)(v), ...

Section 5(a)(vi), ...

Section 5(a)(vii), ...

Section 5(b)(iv), ...

and in relation to Party B for the purpose of:—

Section 5(a)(v), ...

Section 5(a)(vi), ...

Section 5(a)(vii), ...

Section 5(b)(iv), ...

(b) *"Specified Transaction"* will have the meaning specified in Section 14 of this Agreement unless another meaning is specified here ....

....

....

(c) The *"Cross Default"* provisions of Section 5(a)(vi) will/will not * apply to Party A
will/will not * apply to Party B

If such provisions apply:—

"Specified Indebtedness" will have the meaning specified in Section 14 of this Agreement unless another meaning is specified here ....

....

* Delete as applicable.

"Threshold Amount" means ....

....

(d) The ***"Credit Event Upon Merger"*** provisions of Section 5(b)(iv) will/will not * apply to Party A
will/will not * apply to Party B

(e) The ***"Automatic Early Termination"*** provision of Section 6(a) will/will not * apply to Party A
will/will not * apply to Party B

(f) ***Payments on Early Termination.*** For the purpose of Section 6(e) of this Agreement:—

(i) Market Quotation/Loss * will apply.

(ii) The First Method/The Second Method * will apply.

(g) ***"Termination Currency"*** means ...., if such currency is specified and freely available, and otherwise United States Dollars.

(h) ***Additional Termination Event*** will/will not apply*. The following shall constitute an Additional

Termination Event:— ....

....

....

....

....

....

For the purpose of the foregoing Termination Event, the Affected Party or Affected Parties shall be:— . .

....

Part 2. **Tax Representations.**

(a) ***Payer Representations.*** For the purpose of Section 3(e) of this Agreement, Party A will/will not* make the following representation and Party B will/will not* make the following representation:—

It is not required by any applicable law, as modified by the practice of any relevant governmental revenue authority, of any Relevant Jurisdiction to make any deduction or withholding for or on account of any Tax from any payment (other than interest under Section 2(e), 6(d)(ii) or 6(e) of this Agreement) to be made by it to the other party under this Agreement. In making this representation, it may rely on (i) the accuracy of any representations made by the other party pursuant to Section 3(f) of this Agreement, (ii) the satisfaction of the agreement contained in Section 4(a)(i) or 4(a)(iii) of this Agreement and the accuracy and effectiveness of any document provided by the other party pursuant to Section 4(a)(i) or 4(a)(iii) of this Agreement and (iii) the satisfaction of the agreement of the other party contained in Section 4(d) of this Agreement, *provided* that it shall not be a breach of this representation where reliance is placed on clause (ii) and the other party does not deliver a form or document under Section 4(a)(iii) by reason of material prejudice to its legal or commercial position.

(b) ***Payee Representations.*** For the purpose of Section 3(f) of this Agreement, Party A and Party B make the representations specified below, if any:

(i) The following representation will/will not* apply to Party A and will/will not* apply to Party B:—

It is fully eligible for the benefits of the "Business Profits" or "Industrial and Commercial Profits" provision, as the case may be, the "Interest" provision or the "Other Income" provision (if any) of the Specified Treaty with respect to any payment described in such provisions and received or to be received

* Delete as applicable

by it in connection with this Agreement and no such payment is attributable to a trade or business carried on by it through a permanent establishment in the Specified Jurisdiction.

If such representation applies, then:—

"*Specified Treaty*" means with respect to Party A ....

"*Specified Jurisdiction*" means with respect to Party A ....

"*Specified Treaty*" means with respect to Party B ....

"*Specified Jurisdiction*" means with respect to Party B ....

(ii) The following representation will/will not* apply to Party A and will/will not* apply to Party B:—

Each payment received or to be received by it in connection with this Agreement will be effectively connected with its conduct of a trade or business in the Specified Jurisdiction.

If such representation applies, then:—

"*Specified Jurisdiction*" means with respect to Party A ....

"*Specified Jurisdiction*" means with respect to Party B ....

(iii) The following representation will/will not* apply to Party A and will/will not* apply to Party B:—

(A) It is entering into each Transaction in the ordinary course of its trade as, and is, either (1) a recognised U.K. bank or (2) a recognised U.K. swaps dealer (in either case (1) or (2), for purposes of the United Kingdom Inland Revenue extra statutory concession C 17 on interest and currency swaps dated March 14, 1989), and (B) it will bring into account payments made and received in respect of each Transaction in computing its income for United Kingdom tax purposes.

(iv) Other Payee Representations:— ....

....

....

....

N.B. The above representations may need modification if either party is a Multibranch Party.

* Delete as applicable.

Part 3. **Agreement to Deliver Documents.**

For the purpose of Sections 4(a)(i) and (ii) of this Agreement, each party agrees to deliver the following documents, as applicable:—

(a) Tax forms, documents or certificates to be delivered are:—

Party required to deliver document	Form/Document/ Certificate	Date by which to be delivered
....	....	....
....	....	....
....	....	....
....	....	....
....	....	....

(b) Other documents to be delivered are:—

Party required to deliver document	Form/Document/ Certificate	Date by which to be delivered	Covered by Section 3(d) Representation
....	....	....	Yes/No*
....	....	....	Yes/No*
....	....	....	Yes/No*
....	....	....	Yes/No*
....	....	....	Yes/No*

Part 4. **Miscellaneous.**

(a) ***Addresses for Notices.*** For the purpose of Section 12(a) of this Agreement:—

Address for notices or communications to Party A:—

Address: ....

Attention: ....

Telex No.: .... Answerback: ....

Facsimile No.: .... Telephone No.: ....

Electronic Messaging System Details: ....

Address for notices or communications to Party B:—

Address: ....

Attention: ....

Telex No.: .... Answerback: ....

* Delete as applicable.

Facsimile No.: .... Telephone No.: ....

Electronic Messaging System Details: ....

(b) ***Process Agent.*** For the purpose of Section 13(c) of this Agreement:—

Party A appoints as its Process Agent ....

Party B appoints as its Process Agent ....

(c) ***Offices.*** The provisions of Section 10(a) will/will not* apply to this Agreement.

(d) ***Multibranch Party.*** For the purpose of Section 10(c) of this Agreement:—

Party A is/is not* a Multibranch Party and, if so, may act through the following Offices:—

....

....

Party B is/is not* a Multibranch Party and, if so, may act through the following Offices:—

....

....

(e) ***Calculation Agent.*** The Calculation Agent is ...., unless otherwise specified in a Confirmation in relation to the relevant Transaction.

(f) ***Credit Support Document.*** Details of any Credit Support Document:— ....

....

....

....

(g) ***Credit Support Provider.*** Credit Support Provider means in relation to Party A, ...

....

....

Credit Support Provider means in relation to Party B, ...

....

....

(h) ***Governing Law.*** This Agreement will be governed by and construed in accordance with English law/the laws of the State of New York (without reference to choice of law doctrine) *.

* Delete as applicable.

(i) ***Netting of Payments.*** Subparagraph (ii) of Section 2(c) of this Agreement will not apply to the following Transactions or groups of Transactions (in each case starting from the date of this Agreement/in each case starting from .... *). ....

....

....

(j) ***"Affiliate"*** will have the meaning specified in Section 14 of this Agreement unless another meaning is specified here ....

....

Part 5. **Other Provisions.**

* Delete as applicable.

Appendix II

4 Group of Thirty Recommendations on Derivatives

Recommendations[1]

* * * * *

Recommendations for Dealers and End-Users

These recommendations are addressed to participants in derivatives activity, both dealers and end-users. The terms "dealer" and "end-user" do not refer to particular types of institution, but rather to the nature of their derivatives activity. A bank, for instance, may participate both as a dealer and as an end-user. Likewise, some corporate end-users of derivatives may also by involved as dealers. (For information about who uses derivatives and why, see Section II of the Overview of Derivatives Activity.)

General Policies

Recommendation 1: The Role of Senior Management

Dealers and end-users should use derivatives in a manner consistent with the overall risk management and capital policies approved by their boards of directors. These policies should be reviewed as business and market circumstances change. Policies governing derivatives use should be clearly defined, including the purposes for which these transactions are to be undertaken. Senior management should approve procedures and controls to implement these policies, and management at all levels should enforce them.

Derivatives activities merit senior management attention because they can generate significant benefits or costs for any firm. A firm's policies for derivatives should be an integral part of its overall policies for risk taking and management, either in its underlying business (if it is an end-user) or its other lines of business (if it is a dealer). Periodic reviews will help ensure that these policies reflect changing circumstances and innovations.

[1] This text is reproduced with permission from the Group of Thirty. It is an excerpt from *Derivatives: Practices and Principles* (July 1993), prepared by the Global Derivatives Study Group and published by the Group of Thirty, Washington, D.C.

Valuation and Market Risk Management

Recommendation 2: Marking to Market

> *Dealers should mark their derivatives positions to market, on at least a daily basis, for risk management purposes.*

Marking to market is the only valuation technique that correctly reflects the current value of derivatives cash flows to be managed and provides information about market risk and appropriate hedging actions. Lower-of-cost-or-market accounting, and accruals accounting, are not appropriate for risk management.

The Survey of Industry Practice shows that the practice of marking to market daily is widespread among dealers, reflecting the importance of the information it provides to risk managers. Intraday or even real time valuation can help greatly, especially in managing the market risk of some option portfolios.

Recommendation 3: Market Valuation Methods

> *Derivatives portfolios of dealers should be valued based on mid-market levels less specific adjustments, or on appropriate bid or offer levels. Mid-market valuation adjustments should allow for expected future costs such as unearned credit spread, close-out costs, investing and funding costs, and administrative costs.*

Marking to mid-market less adjustments specifically defines and quantifies adjustments that are implicitly assumed in the bid or offer method. Using the mid-market valuation method without adjustment would overstate the value of a portfolio by not deferring income to meet future costs and to provide a credit spread.

Two adjustments to mid-market are necessary even for a perfectly matched portfolio: the "unearned credit spread adjustment" to reflect the credit risk in the portfolio; and the "administrative costs adjustment" for costs that will be incurred to administer the portfolio. The unearned credit spread adjustment represents amounts set aside to cover expected credit losses and to provide compensations for credit exposure. Expected credit losses should be based upon expected exposure to counterparties (taking into account netting arrangements), expected default experience, and overall portfolio diversification. The unearned credit spread should preferably be adjusted dynamically as these factors change. It can be calculated on a transaction basis, on a portfolio basis, or across all activities with a given client.

Two additional adjustments are necessary for portfolios that are not perfectly matched: the "close-out costs adjustment" which factors in the

cost of eliminating their market risk; and the "investing and funding costs adjustment" relating to the cost of funding and investing cash flow mismatches at rates different from the LIBOR rate which models typically assume.

The Survey reveals a wide range of practice concerning the mark-to-market method and the use of adjustments to mid-market value. The most commonly used adjustments are for credit and administrative costs.

Recommendation 4: Identifying Revenue Sources

Dealers should measure the components of revenue regularly and in sufficient detail to understand the sources of risk.

By identifying and isolating individual sources of revenue, dealers develop a more refined understanding of the risks and returns of derivatives activities. Components of revenue generally include origination revenue, credit spread revenue, if applicable, and other trading revenue. It is useful, though complex, to split other trading revenue among components of market risk.

The Survey of Industry Practice indicates that few dealers identify individual sources of revenue. This should become a more common practice.

Recommendation 5: Measuring Market Risk

Dealers should use a consistent measure to calculate daily the market risk of their derivatives positions and compare it to market risk limits.

- ***Market risk is best measured as "value at risk" using probability analysis based upon a common confidence interval (e.g., two standard deviations) and time horizon (e.g., a one-day exposure).***
- ***Components of market risk that should be considered across the term structure include: absolute price or rate change (delta); convexity (gamma); volatility (vega); time decay (theta); basis or correlation; and discount rate (rho).***

Reducing market risks across derivatives to a single common denominator makes aggregation, comparison, and risk control easier. "Value at risk" is the expected loss from an adverse market movement with a specified probability over a particular period of time. For example, with 97.5% probability (that is, a "confidence interval" of 97.5%), corresponding to calculations using about two standard deviations, it can be determined that any change in portfolio value over one day resulting from an adverse market movement will not exceed a specific amount. Conversely, there is a 2.5% probability of experiencing an adverse change in excess of the calculated amount.

Value at risk should encompass changes in all major market risk components listed in the recommendation. The difficulty in applying the technique of value at risk increases with the complexity of the risks being managed. For comparability, value at risk should be calculated to a common confidence interval and time horizon.

For most portfolios without options, once the expected loss is known for events with a given probability, the loss for a more likely or less likely scenario can easily be deduced. Therefore, for such portfolios, the choice of confidence interval is of no great significance. For option-based portfolios, however, this does not hold true. In their case, it would also be useful to calculate the loss from more and less likely scenarios.

A time horizon of one day is consistent with Recommendation 2 for daily marking to market, which allows management to know and decide daily any change of the risk profile.

Once a method of risk measurement is in place, market risk limits must be decided based on factors such as: management tolerance for low probability extreme losses versus higher probability modest losses; capital resources; market liquidity; expected profitability; trader experience; and business strategy.

The Survey suggests that most dealers know and consider some or all of the components of market risk. However, the use of one consistent measure of market risk, such as value at risk, is more prevalent among large dealers.

Recommendation 6: Stress Simulations

> *Dealers should regularly perform simulations to determine how their portfolios would perform under stress conditions.*

Simulations of improbable market environments are important in risk analysis because many assumptions that are valid for normal markets may no longer hold true in abnormal markets.

These simulations should reflect both historical events and future possibilities. Stress scenarios should include not only abnormally large market swings but also periods of prolonged inactivity. The tests should consider the effect of price changes on the mid-market value of the portfolio, as well as changes in the assumptions about the adjustments to mid-market (such as the impact that decreased liquidity would have on close-out costs). Dealers should evaluate the results of stress tests and develop contingency plans accordingly.

The Survey indicates that some stress testing is being conducted, mainly by large dealers, and that broader usage is planned.

Recommendation 7: Investing and Funding Forecasts

Dealers should periodically forecast the cash investing and funding requirements arising from their derivatives portfolios.

The frequency and precision of forecasts should be determined by the size and nature of mismatches. A detailed forecast should determine surpluses and funding needs, by currency, over time. It also should examine the potential impact of contractual unwind provisions or other credit provisions that produce cash or collateral receipts or payments.

The Survey indicates that at present, half of responding dealers are conducting forecasts of cash investing and funding requirements. This type of forecast should become a more common practice.

Recommendation 8: Independent Market Risk Management

Dealers should have a market risk management function, with clear independence and authority, to ensure that the following responsibilities are carried out:

- *The development of risk limit policies and the monitoring of transactions and positions for adherence to these policies. (See Recommendation 5.)*
- *The design of stress scenarios to measure the impact of market conditions, however improbable, that might cause market gaps, volatility swings, or disruptions of major relationships, or might reduce liquidity in the face of unfavorable market linkages, concentrated market making, or credit exhaustion. (See Recommendation 6.)*
- *The design of revenue reports quantifying the contribution of various risk components, and of market risk measures such as value at risk. (See Recommendations 4 and 5.)*
- *The monitoring of variance between the actual volatility of portfolio value and that predicted by the measure of market risk.*
- *The review and approval of pricing models and valuation systems used by front- and back-office personnel, and the development of reconciliation procedures if different systems are used.*

The growth of activities in derivatives and other financial instruments has led many firms to establish market (and credit) risk management functions to assist senior management in establishing consistent policies and procedures applicable to various activities. Market risk management is typically headed by a board level or near board level executive.

The market risk management function acts as a catalyst for the development of sound market risk management systems, models and procedures. Its review of trading performance typically answers the question: Are results consistent with those suggested by analysis of value at risk? The risk management function is rarely involved in actual risk-taking decisions.

According to the Survey, a large majority of dealers already have such a function in place and over 50% of those that do not, plan to establish one in the near future.

Recommendation 9: Practices by End-Users

As appropriate to the nature, size, and complexity of their derivatives activities, end-users should adopt the same valuation and market risk management practices that are recommended for dealers. Specifically, they should consider: regularly marking to market their derivatives transactions for risk management purposes; periodically forecasting the cash investing and funding requirements arising from their derivatives transactions; and establishing a clearly independent and authoritative function to design and assure adherence to prudent risk limits.

While many end-users do not expect significant change in the combined value of their derivatives positions and the underlying positions, others do. Derivatives are customer-specific transactions, often designed to offset precisely the market risk of an end-user's business position (e.g., buying a commodity as a raw material). End-users should establish the performance assessment and control procedures that are appropriate for their derivatives activities.

Less than half of those end-users surveyed currently mark their derivatives hedges to market for risk management purposes. About half plan to do so.

Credit Risk Measurement and Management

Recommendation 10: Measuring Credit Exposure

Dealers and end-users should measure credit exposure on derivatives in two ways:

- *Current exposure, which is the replacement cost of derivatives transactions, that is, their market value.*
- *Potential exposure, which is an estimate of the future replacement cost of derivatives transactions. It should be calculated using probability analysis based upon broad confidence intervals (e.g., two standard deviations) over the remaining terms of the transactions.*

To assess credit risk, a dealer or end-user should ask two questions. If a counterparty were to default today, what would it cost to replace the derivatives transaction? If a counterparty defaults in the future, what is a reasonable estimate of the future replacement cost?

Current exposure is an accurate measure of credit risk that addresses the first question. It simply evaluates the replacement cost of outstanding derivatives commitments. The result can be positive or negative. It is an important measure of credit risk as it represents the actual risk to a counterparty at any point in time. The regular calculation of current exposure is a broadly accepted practice today.

Potential exposure is more difficult to assess, and the methods used to determine it vary. The most rigorous methods use either simulation analysis or option valuation models. The analysis generally involves a statistical modeling or option valuation models. The analysis generally involves a statistical modeling of the effects on the value of the derivatives of movement in the prices of the underlying variables (such as interest rates, exchange rates, equity prices, or commodity prices). These techniques are often used to generate two measures of potential exposure: expected exposure; and maximum or "worst case" exposure.

Dealers and end-users that cannot justify the simulation and statistical systems needed to perform such potential exposure calculations should use tables of factors developed under the same principles. The factors used should differentiate appropriately by type and maturity of transaction and be adjusted periodically for changes in market conditions.

The Survey shows that dealers use several different methods for calculating credit exposures. These include: the BIS original and current exposure methods, used by one-third of all dealers; methods based on worst-case scenarios applied to each transaction, used by about a quarter of dealers and expected to become the most common in the future; and methods that rely upon tables of factors, used by almost 40% of dealers. End-users tend to rely on simpler methods primarily based on notional amounts.

Recommendation 11: Aggregating Credit Exposures

> ***Credit exposures on derivatives, and all other credit exposures to a counterparty, should be aggregated taking into consideration enforceable netting arrangements. Credit exposures should be calculated regularly and compared to credit limits.***

In calculating the current credit exposure for a portfolio of transactions with a counterparty, the first question is whether netting applies. If it

does, the current exposure is simply the sum of positive and negative exposures on transactions in the portfolio.

The calculation of potential exposure is more complicated. Simply summing the potential exposures of all transactions will in most cases dramatically overstate the actual exposure, even if netting does not apply. This is because a straight summation fails to take into account transactions in the portfolio that offset each other or that have peak potential exposures at different times. The most accurate calculation of potential exposure simulates the entire portfolio. Although portfolio-level simulation is not commonly used by dealers at present, they should pursue it more widely to avoid overstating aggregate exposure.

Credit exposures should be calculated regularly. In particular, dealers should monitor current exposures daily; they can generally measure potential exposures less frequently. End-users with derivative portfolios should also periodically assess credit exposures. For them, the appropriate frequency will depend upon how material their credit exposures are.

Credit exposures should also be regularly compared to credit limits, and systems should be in place to monitor when limits are approached or exceeded, so that management can take appropriate actions.

By aggregating credit exposures on derivatives as described above, participants will have a consistent basis for comparison with other credit exposures including those resulting from on-balance-sheet activity. This would permit a more effective evaluation of the adequacy of credit reserves relative to overall credit exposure.

The Survey suggests that most dealers monitor gross credit use against limits. Aggregating current and potential exposures by counterparty on a net basis is not common among dealers, although some who do not net at present plan to in the future. Frequent monitoring of credit exposure is widespread among dealers, with three-quarters of respondents doing it either intraday or overnight. The majority of end-users monitor credit exposures at least once a month.

Recommendation 12: Independent Credit Risk Management

Dealers and end-users should have a credit risk management function with clear independence and authority, and with analytical capabilities in derivatives, responsible for:

- *Approving credit exposure measurement standards.*
- *Setting credit limits and monitoring their use.*
- *Reviewing credits and concentrations of credit risk.*

- *Reviewing and monitoring risk reduction arrangements.*

For dealers, credit exposures should be monitored by an independent credit risk management group. According to the Survey, most dealers and some end-users have such a group. For end-users, this role may not necessarily be performed by a separate group; however, the credit risk should be managed independently from dealing personnel. This separation of responsibility is intended to prevent conflicts of interest and to ensure that credit exposure is assessed objectively. The credit risk management function should approve exposure management standards, and should establish credit limits for counterparties consistent with these standards. Specifically, it should conduct an internal credit review before engaging in transactions with a counterparty, and should guide the use of documentation and credit support tools. Credit limits and guidelines should ensure that only those potential counterparties that meet the appropriate credit standards, with or without credit support, become actual counterparties.

The credit risk management function should continually review the creditworthiness of counterparties and their credit limits.

Recommendation 13: Master Agreements

Dealers and end-users are encouraged to use one master agreement as widely as possible with each counterparty to document existing and future derivatives transactions, including foreign exchange forwards and options. Master agreements should provide for payments netting and close-out netting, using a full two-way payments approach.

Participants should use one master agreement with each counterparty. That agreement should provide for close-out and settlement netting as widely as possible to document derivatives transactions. In particular, there is substantial scope for reducing credit risk by including foreign exchange forwards and options under master agreements along with other derivatives transactions.

A single master agreement that documents transactions between two parties creates the greatest legal certainty that credit exposure will be netted. The use of multiple master agreements between two parties introduces the risk of "cherry-picking" among master agreements (rather than among individual transactions); and the risk that the right to set off amounts due under different master agreements might be delayed. Dealers and end-users will be well served by using a single master agreement with counterparties to document as many derivatives transactions as law or regulation permit. The practices of using separate agreements for each transaction between two parties, or standard terms that do not con-

stitute a master agreement, are not good practices and should be discontinued. According to the Survey, two-fifths of all dealers now document derivatives transactions under a multi-product master, and more plan to do so in the future.

Full two-way payments, as opposed to limited two-way payments, is now the preferred payments approach in master agreements. Under full-two-way payments, the net amount calculated through the netting provisions in a bilateral master agreement is due regardless of whether it is to, or from, the defaulting party. Under limited two-way payments, the defaulting party is not entitled to receive anything, even if the net amount is in its favor. This discourages default and enhances cross-product and cross-affiliate set-off. However, when master agreements cover a wide range of derivatives transactions, the benefits created by increasing the certainty about the value of a net position under full two-way payments outweigh any possible benefits under limited two-way payments.

Recommendation 14: Credit Enhancement

Dealers and end-users should assess both the benefits and costs of credit enhancement and related risk-reduction arrangements. Where it is proposed that credit downgrades would trigger early termination or collateral requirements, participants should carefully consider their own capacity and that of their counterparts to meet the potentially substantial funding needs that might result.

Credit risk reduction arrangements can be useful in the management of counterparty credit risk. These include collateral and margin arrangements; third-party credit enhancement such as guarantees or letters of credit; and structural credit enhancement though the establishment of special-purpose vehicles to conduct derivatives business.

The Survey indicates that about two-thirds of dealers are prepared to accept credit enhancement with cash or securities as collateral, and over three-quarters accept a third-party guarantee or enhancement. Reflecting strong dealer credit ratings, only one-third are prepared to provide cash or securities collateral and only 10% or so will offer a third-party guarantee.

Enforceability

Recommendation 15: Promoting Enforceability

Dealers and end-users should work together on a continuing basis to identify and recommend solutions for issues of legal enforceability, both within and across jurisdictions, as activities evolve and new types of transactions are developed.

Dealers regularly develop new types of transactions, and new technologies are developed to confirm them. These developments may not fit clearly within the current legal framework in the jurisdictions where transactions occur. Therefore, dealers and end-users should continue to work together to evaluate the developments in light of existing laws to assess what legal issues may arise. They should take the initiative to ensure that risks arising from these developments can be properly handled through analysis, market practices, documentation and, when necessary, legislation.

Enforceability of netting provisions is considered a serious concern by 43% of dealer senior management responding to the Survey, and another 45% consider it to be of some concern. It also is considered a serious issue by management of many end-users.

Systems, Operations, and Controls

Recommendation 16: Professional Expertise

> ***Dealers and end-users must ensure that their derivatives activities are undertaken by professionals in sufficient number and with the appropriate experience, skill levels, and degrees of specialization. These professionals include specialists who transact and manage the risks involved, their supervisors, and those responsible for processing, reporting. controlling, and auditing the activities.***

To establish good management, derivatives activities must be staffed by talented, well-trained and responsible professionals. There is a danger, however, in relying on a few specialists, and it is essential that their managers understand not only derivatives but also the broader business context.

Derivatives support functions are technical and generally require a level of expertise higher than for other financial instruments or activities. Respondents to the Survey expressed concern that, while they are satisfied with the quality of staff in line derivatives activities, the quality of support staff lags. Developing expertise through training programs and appropriate standards of professionalism is encouraged.

The Survey indicates that, for the majority of respondent dealers, senior management is confident about the general quality of its derivatives professionals. To the extent it is concerned about issues of professionalism, it is more worried about its own lack of understanding, about insufficient understanding of derivatives by other functions, and about overreliance on a few specialists.

Recommendation 17: Systems

Dealers and end-users must ensure that adequate systems for data capture, processing, settlement, and management reporting are in place so that derivatives transactions are conducted in an orderly and efficient manner in compliance with management policies. Dealers should have risk management systems that measure the risks incurred in their derivatives activities including market and credit risks. End-users should have risk management systems that measure the risks incurred in their derivatives activities based upon their nature, size and complexity.

The size and scope of the required systems will depend upon the nature and scale of an organization's derivatives transactions.

For dealers, operating efficiency and reliability are enhanced through the development of systems that minimize manual intervention. Those benefits are particularly significant for dealers with a large volume of activity and a high degree of customization of transactions. At the moment, confirmations of transactions, for example, are automated for about 40% of dealers, some 10% are partially automated, and another 45% rely on manual systems. Eighty percent plan to automate their confirmations completely. In addition, large dealers have made significant investments to integrate back- and front-office systems for derivatives with their firms' other management information systems. Dealers that have done so have found that the integration further enhances operating efficiency and reliability.

While end-users may invest less extensively in their systems than dealers do, these should still be sufficient to group exposures and analyze aggregated risk in a meaningful and useful way.

Recommendation 18: Authority

Management of dealers and end-users should designate who is authorized to commit their institutions to derivatives transactions.

Authority may be delegated to certain individuals or to persons holding certain positions within the firm. Management may choose to limit authority to certain types of transactions, for example to certain maturities, amounts or types of underlying risks. It is essential that this information be understood within the firm.

Participants should communicate information on which individuals have the authority to commit to counterparties. They should recognize, however, that the legal doctrine of "apparent authority" may govern transactions they enter into, and that there is no substitute for appropriate internal controls.

Two-thirds of dealers responding to the Survey involve senior management in authorizing traders to commit the firm.

Accounting and Disclosure

Recommendation 19: Accounting Practices

International harmonization of accounting standards for derivatives is desirable. Pending the adoption of harmonized standards, the following accounting practices are recommended:

- *Dealers should account for derivatives transactions by marking them to market, taking changes in value to income in each period.*
- *End-users should account for derivatives used to manage risks so as to achieve a consistency of income recognition treatment between those instruments and the risks being managed. Thus, if the risk being managed is accounted for at cost (or, in the case of an anticipatory hedge, not yet recognized), changes in the value of a qualifying risk management instrument should be deferred until a gain or loss is recognized on the risk being managed. Or, if the risk being managed is marked to market with changes in value being taken to income, a qualifying risk management instrument should be treated in a comparable fashion.*
- *End-users should account for derivatives not qualifying for risk management treatment on a mark-to-market basis.*
- *Amounts due to and from counterparties should only be offset when there is a legal right to set off or when enforceable netting arrangements are in place.*

Where local regulations prevent adoption of these practices, disclosure along these lines is nevertheless recommended.

Accounting policies for derivatives vary widely around the world. In some countries there are local accounting standards that address accounting for derivatives; in other countries there are no specific standards and a variety of customs and practices has developed. In view of the global nature of derivatives, it is desirable to achieve some harmonization of accounting treatment to assist in clarifying the financial statements of dealers and end-users.

The recommendation for dealers to account for changes in the value of their derivatives positions in income during each period has become standard in many, although not all, countries. It provides a better representation of the economic effects of such positions than other methods.

The recommended accounting treatment for end-users using derivatives to manage risks, referred to as "risk management accounting," is also a standard treatment. It has evolved in many countries, at least in a modified form, as a response to anomalies in the existing accounting framework. Traditionally in some countries, this accounting treatment has been applied solely to transactions undertaken to reduce risks, usually referred to as "hedges."

Policies must define when financial instruments are eligible for risk management accounting to ensure that the method is not abused.

Among a majority of dealers who responded to the Survey, senior management thought inconsistency of accounting standards with the economics of the business were either of serious or some concern.

Recommendation 20: Disclosures

Financial statements of dealers and end-users should contain sufficient information about their use of derivatives to provide an understanding of the purposes for which transactions are undertaken, the extent of the transactions, the degree of risk involved, and how the transactions have been accounted for. Pending the adoption of harmonized accounting standards, the following disclosures are recommended:

- *Information about management's attitude to financial risks, how instruments are used, and how risks are monitored and controlled.*
- *Accounting policies.*
- *Analysis of positions at the balance sheet date.*
- *Analysis of the credit risk inherent in those positions.*
- *For dealers only, additional information about the extent of their activities in financial instruments.*

The Survey shows that the quality of the financial statement disclosure about derivatives transactions varies even more widely than the accounting policies that are applied. Until local standards-setting bodies can adopt harmonized standards, there is a need to improve the quality of financial statement disclosure concerning transactions in both derivatives and cash market instruments.

Its qualitative nature dictates that information about management's attitude to financial risks, how instruments are used, and how risks are monitored and controlled, should appear in the management analysis section of the annual report. The remaining information should appear in the footnotes to financial statements and be commented on as appropriate in the management analysis.

This recommendation is not apparently precluded by accounting regulations in any country and its early adoption is encouraged.

Inadequate public disclosure of exposures of counterparties is of some concern, or of serious concern, to about three-fifths of senior management among dealers responding to the Survey.

Recommendations for Legislators, Regulators, and Supervisors

Recommendation 21: Recognizing Netting

> *Regulators and supervisors should recognize the benefits of netting arrangements where and to the full extent that they are enforceable, and encourage their use by reflecting these arrangements in capital adequacy standards. Specifically, they should promptly implement the recognition of the effectiveness of bilateral close-out netting in bank capital regulations.*

The bilateral or multilateral netting of contractual payments due on settlement dates, and of unrealized losses against unrealized gains in the event of a counterparty's default, is the most important means of mitigating credit risk. By reducing settlement risk as well as credit exposures, netting contributes to the reduction of systemic risk.

Significant efforts have been made to develop standard master agreements that effect netting across the full range of derivatives products. Nonetheless, the enforceability of such netting provisions remains among the highest concerns of senior management of derivatives dealers, according to the Survey.

Regulators and supervisors should officially recognize netting where and to the full extent it is enforceable, and reflect these arrangements in the capital standards. In this way, regulators and supervisors will stimulate efforts to resolve uncertainties where they exist and create tangible incentives for using this most important method of reducing counterparty risk.

An important step in implementing this recommendation was taken in April of this year when the Basle Committee released a Consultative Paper that included a proposal for recognizing the effectiveness of close-out netting. This is an amendment to the agreed framework of measuring bank capital adequacy (the "Basle Accord") published by the Basle Committee in July 1988. When the consultation period for this proposal has ended, the national supervisory authorities represented on the Basle Committee should recognize and implement bilateral close-out nettings for capital purposes.

Recommendation 22: Legal and Regulatory Uncertainties

Legislators, regulators, and supervisors, including central banks, should work in concert with dealers and end-users to identify and remove any remaining legal and regulatory uncertainties with respect to:

- ***The form of documentation required to create legally enforceable agreements (statute of frauds).***
- ***The capacity of parties, such as governmental entities, insurance companies, pension funds, and building societies, to enter into transactions*** (ultra vires).
- ***The enforceability of bilateral close-out netting and collateral arrangements in bankruptcy.***
- ***The enforceability of multibranch netting arrangements in bankruptcy.***
- ***The legality/enforceability of derivatives transactions.***

These five main enforceability risks are analyzed for nine major jurisdictions in Appendix II (bound separately). Regulators and legislators in these jurisdictions should remove the remaining uncertainties that have been identified. In other countries, market participants, regulators, and legislators should work to identify and resolve any similar legal risks. These efforts should be conducted on a continuing basis, to account for new types of derivatives transactions and new technologies. It is important to approach these issues aggressively so that the largest risks faced by dealers and end-users are not legal risks from legal systems that have not kept pace with financial developments.

Further work on the enforceability in bankruptcy or insolvency of bilateral netting and collateral arrangements is particularly important if the credit risk reduction techniques for derivatives are to evolve. These techniques are essential building blocks for enforceable multilateral netting arrangements, if that is a direction participants choose to take.

Recommendation 23: Tax Treatment

Legislators and tax authorities are encouraged to review and, where appropriate, amend tax laws and regulations that disadvantage the use of derivatives in risk management strategies. Tax impediments include the inconsistent or uncertain tax treatment of gains and losses on the derivatives, in comparison with the gains and losses that arise from the risks being managed.

In most, if not all jurisdictions, the tax treatment being applied to derivatives transactions dates back to before they came into general use.

This can lead to considerable uncertainty in determining how gains and losses associated with these instruments should be taxed depending upon their use.

These uncertainties and inconsistencies present real difficulties to organizations that seek to use derivatives to manage risks in their businesses. Confusion can discourage them from pursuing commercially sensible risk management strategies.

Recommendation 24: Accounting Standards

Accounting standards-setting bodies in each country should, as a matter of priority, provide comprehensive guidance on accounting and reporting of transactions in financial instruments, including derivatives, and should work towards international harmonization of standards on this subject. Also, the International Accounting Standards Committee should finalize its accounting standard on Financial Instruments.

At present no country has accounting and reporting standards that comprehensively address all financial instruments, including derivatives. Even in those countries where development of accounting standards is considered far advanced, there are gaps or inconsistencies between different standards. This is an area where action needs to be taken as a matter of priority.

In a number of countries, accounting standards-setters have recognized the need to improve accounting standards in this area and some have commenced work. Furthermore, the International Accounting Standards Committee (IASC) has issued an exposure draft on Financial Instruments (E40) and presently intends to finalize an accounting standard by the end of 1993.

In addressing the accounting and disclosure requirements for financial instruments, the IASC and national accounting standards-setters are encouraged to address the problems of accounting for risk management activities. Most existing accounting regulations were formulated before recent advances in risk management strategies. This poses considerable practical problems, both to end-users and dealers. Developments in accounting regulations have not kept pace with changes in the way risk is managed.

In some countries, the accounting standards that govern the eligibility for hedge accounting treatment of hedges of anticipated transactions may be too restrictive: some relaxation should be permitted, subject to safeguards to prevent abuse.

Similarly, accounting standards should deal with risk management in a broad sense and not deal just with risk reduction (hedging) which is only one aspect of risk management. Risk management strategies are increasingly being used by both financial and nonfinancial institutions to achieve an acceptable risk profile, but not necessarily a reduced level of risk. Concern over current accounting regulations is deterring some organizations from pursuing commercially sensible risk management strategies. While standards are necessary to ensure that risk management accounting is not abused, it is essential that accounting standards respond to modern risk management techniques.

Appendix II

5 Joint Report on the Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms

[Excerpt]

II. Catalogue of information for supervisory purposes*

16. In monitoring the activities of a financial institution involved in derivatives, supervisors need to be satisfied that the firm has the ability to measure, analyze and manage these risks. In order to achieve these objectives, supervisors should seek to ensure that the firm has both quantitative and qualitative information on its derivatives activities.

17. *Quantitative information.* Quantitative information about derivatives activities should address the following broad areas:

- credit risk
- liquidity risk
- market risk
- earnings

Recognizing that exchange-traded and OTC derivatives generally differ in their credit risk, liquidity risk and the potential for complexity, the overall reporting framework distinguishes between exchange-traded and OTC derivatives in identifying information needed for supervisory assessment. Each of the four broad areas is discussed in greater detail in sections 1 to 4 below.

18. *Qualitative information.* In order to effectively evaluate banks' and securities firms' derivatives activities and related risks, supervisors should assess *qualitative* information about institutions' systems, policies and practices for measuring and managing the risk of derivatives. This includes, for example, information on the risk limits that banks and securities firms use to manage their exposures and any changes in these limits. The risk

* This text is reproduced with permission from the Basle Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissions (IOSCO). It is an excerpt from *Framework for Supervisory Information about the Derivatives Activities of Banks and Securities Firms* (May 1995), prepared by the Basle Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissions.

management guidelines for derivatives, which were issued by the two Committees in July 1994 and which highlight key attributes of the risk management systems of banks and securities firms, may be used as a guide in requesting information on institutions' systems, policies and practices.[4]

19. The following sections describe in greater detail the different elements of the framework for supervisory information about derivatives activities. The narrative discussion is summarized in tabular form in Annex 1. In Annex 1, two columns are provided for each of the major risk categories. The first column identifies a supervisory concern or use, and the second column describes the information that could be applicable to that use. Explanations follow that summarize how each data item might be used or why it is important from a supervisory perspective. In general, the data and related explanations reflect widely accepted concepts and techniques for measurement of risk exposure that are based on new developments in practice. Some information elements address multiple supervisory uses listed in the first column of Annex 1. To summarize such overlaps, Annex 2 cross-references the information elements with the supervisory uses that have been identified.**

1. Credit risk

20. Credit risk is the risk that a counterparty may fail to fully perform on its financial obligations. With respect to derivatives, it is appropriate to differentiate between the credit risk of exchange-traded and OTC instruments. Owing to the reduction in credit risk achieved by organized exchanges and clearing houses, supervisors may need to evaluate less information on exchange-traded derivatives for credit risk purposes than on OTC instruments. Accordingly, the following discussion on credit risk pertains primarily to OTC contracts.[5]

21. The Committees recognize that the notional amount of OTC derivative contracts does not reflect the actual counterparty risk. Credit risk for an OTC contract is best broken into two components, current credit exposure to the counterparty and the potential credit exposure that

---

[4] *Risk Management Guidelines for Derivatives*, Basle Committee on Banking Supervision, July 1994, and *Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms*. Technical Committee of IOSCO, July 1994.

** Annex 1 and 2 are not reprinted herein.

[5] Credit risk is of most concern in the case of OTC derivative contracts since exchange clearing houses for derivatives employ risk management systems that substantially mitigate credit risks to their members. Both futures and options exchanges typically mark exposures to market each day. In the case of futures exchanges, members' exposures to the clearing house are eliminated each day, and often intra-day, through variation margin payments. In the case of options exchanges, clearing house exposures to written options are fully collateralised.

may result from changes in the market value underlying the derivative contract. To the extent possible, credit risk from derivatives should be considered as part of an institution's overall credit risk exposure. This should include exposure from other off-balance-sheet credit instruments such as standby letters of credit as well as the credit risk from on-balance-sheet positions.

(a) Current credit exposure

22. Current credit exposure is measured as the cost of replacing the cash flow of contracts with positive mark-to-market value (replacement cost) if the counterparty defaults. Legally enforceable bilateral netting agreements can significantly reduce the amount of an institution's credit risk to each of its counterparties. These netting agreements can extend across different product types such as foreign exchange, interest rate, equity-linked and commodity contracts. Therefore, an institution's current credit exposure from derivative contracts is best measured as the positive mark-to-market replacement cost of all derivative products on a counterparty by counterparty basis, taking account of any legally enforceable bilateral netting agreements.

23. For individual institutions, breaking out the gross positive and negative market values of contracts may have supervisory value by providing an indication of the extent to which legally enforceable bilateral netting agreements reduce an institution's credit exposure.

(b) Potential credit exposure

24. In light of the potential volatility of replacement costs over time, prudential analysis should not only focus on replacement cost at a given point in time but also on its potential to change. Potential credit exposure can be defined as the exposure of the contract that may be realized over its remaining life due to movements in the rates or prices underlying the contract. For banks, under the requirements of the 1988 Basle Capital Accord, potential exposure is captured through a so-called "add-on," which is calculated by multiplying the contract's gross or effective[6] notional principal by a conversion factor that is based on the price volatility of the underlying contract. Bank supervisors should therefore evaluate information on the add-ons that banks must already compile for their risk-based capital calculations. Such information could include notional amounts by product category (i.e. interest rate, foreign exchange, equities, precious metals and other commodities) and by remaining maturity

[6] Effective notional principal is obtained by adjusting the notional amount to reflect the true exposure of contracts that are leveraged or otherwise enhanced by the structure of the transaction.

(i.e. one year or less, over one year to five years and more than five years). The Basle Accord defines remaining maturity as the maturity of the derivative contract. However, supervisors could also take into account information on the instrument underlying the derivative contract.

25. Some banks and securities firms have developed sophisticated simulation models that may produce more precise estimates of their potential credit exposures than under the add-ons approach, and supervisors may wish to take account of the results of these models. These models are generally based on probability analysis and techniques modelling the volatility of the underlying variables (exchange rates, interest rates, equity prices, etc.) and the expected effect of movements of these variables on the contract value over time. Estimates of potential credit exposure by simulations are heavily influenced by the parameters used (a discussion of the major parameters that can influence simulation results is included in the market risk section below). Supervisors and firms should discuss the parameters and other aspects of the models to ensure an appropriate level of understanding and confidence in the use of such models.

(c) Credit enhancements

26. Information on credit enhancements used in connection with OTC derivative transactions is important to an effective supervisory assessment of the credit risk inherent in an institution's derivatives positions. Collateral can be required by an institution to reduce both its current and potential credit risk exposure. Collateral held against the current exposure of derivative contracts with a counterparty effectively reduces credit risk and, therefore, merits supervisory attention. However, supervisors need to consider the legal enforceability of netting agreements and the quality and marketability of collateral.[7] For supervisory analysis purposes, collateral held by an institution in excess of its netted credit exposure to a counterparty would not reduce current credit exposure below zero but could reduce potential credit exposure. Supervisors could obtain a better understanding of how collateral reduces credit risk by collecting information separately on collateral with a market value less than or equal to the netted current exposure to the counterparty and collateral with market values in excess of the netted current exposure and of the nature of that collateral.

27. OTC contract provisions that require a counterparty to post initial collateral (or additional collateral as netted current exposure increases) may be used to reduce potential credit exposure. An OTC contract that

[7] For example, supervisors could obtain additional insights through information on OTC contracts with collateral recognized under the Basle Capital Accord (for banks) and OTC contracts with other readily marketable, high quality securities as collateral.

is subject to a collateral or margin agreement may have lower potential exposure, since collateral would be required in the future to offset any increase in credit exposure. Accordingly, information about the notional amount and market value of OTC contracts subject to collateral agreements could enhance supervisory understanding of an institution's potential credit risk.

(d) Concentration of credit risk

28. As with loans, an identification of significant counterparty OTC credit exposures relative to an institution's capital is important for an evaluation of credit risk. This information should be evaluated together with qualitative information on an institution's credit risk controls. To identify significant exposures and limit reporting burden, supervisors could focus on those counterparties presenting netted current and potential credit exposure above a certain threshold. As a minimum, supervisors could identify the 10 largest counterparties to which an institution is exposed, subject to the minimum threshold used.

29. Since counterparty exposure may stem from different instruments, overall risk concentrations with single counterparties or groups of counterparties cannot be measured accurately if the analysis is limited to single instruments (e.g. swaps) or classes of instruments (e.g. OTC derivatives). For this reason, institutions should aim to monitor counterparty exposures on an integrated basis, taking into consideration both cash instruments and off-balance-sheet relationships. Supervisors could also consider information on exposure to counterparties in specific business sectors or to counterparties within a certain country or region.

30. Supervisors could also analyze information on aggregate exposures to various exchanges, both on- and off-balance-sheet, and on exposures to certain types of collateral supporting derivative instruments. Overexposure to specific issues or markets can lead to additional credit concerns, particularly in the case of banks and securities firms with significant activity in securities markets. Some securities supervisors address this concentration risk by deducting from capital all positions above a certain level of market turnover or by applying some other suitable benchmarks. Supervisors without such provisions should ensure that they are at least informed about these concentrations, whether in the form of holdings of the underlying security itself or in the form of OTC derivatives positions which require the firm to deliver or receive such concentrated positions.

(e) Counterparty credit quality

31. Credit risk is jointly dependent upon credit exposure to the counterparty and the probability of the counterparty's default. Information on the current and potential credit exposure to counterparties of various

credit quality would increase supervisory insights into the probability of credit loss. Information indicative of counterparty credit quality includes total current and potential credit exposure—taking into account legally enforceable bilateral netting agreements—to counterparties with various characteristics, e.g. Basle Capital Accord risk weights (for banks), credit ratings assigned by rating agencies, or the institution's internal credit rating system. Information on guarantees, standby letters of credit, or other credit enhancements may also enhance supervisory understanding of credit quality. Aggregate information on past-due status and past-due information by major counterparties, together with information on actual credit losses, may be of particular interest for identifying pending counterparty credit quality problems in the OTC derivatives markets.

2. Liquidity risk

32. As with cash instruments, there are two basic types of liquidity risk that can be associated with derivative instruments: market liquidity risk and funding risk.

(a) Market liquidity risk

33. Market liquidity risk is the risk that a position cannot be eliminated quickly by either liquidating the instrument or by establishing an offsetting position. Information that breaks out exchange-traded and OTC derivatives could further supervisory understanding of an institution's market liquidity risk. Although exchange-traded and OTC markets both contain liquid and illiquid contracts, the basic differences between the two markets give an indication of the comparative difficulty of offsetting exposures using other instruments.[8] Among both OTC and exchange-traded products, information on broad risk categories (i.e. interest rate, foreign exchange, equities and commodities) and types of instrument would be useful in judging the market liquidity of an institution's positions. Accordingly, notional amounts and market values of exchange-traded and OTC instruments by type (and perhaps by maturity and by product) could enhance a supervisor's understanding of an institution's market liquidity risk. In addition, supervisors could gain important insights into an institution's market liquidity by taking into account the availability of alternative hedging strategies and closely substitutable instruments.

34. To understand the market liquidity risk arising from an institution's derivatives activities, supervisors would benefit greatly from a picture of

[8] Market illiquidity may stem from the customized nature of some OTC contracts which can include fundamental elements of market risk in combinations that may not be easily replicated using standardized exchange-traded contracts or other OTC instruments.

the aggregate size of the market in which the institution is active. This is particularly important for OTC derivatives, which are generally tailored to the specific needs of customers and for which marking to market is more difficult than for standardized products with liquid markets. As a result, it may be difficult to unwind a position in an appropriate time frame because of its size, the availability of suitable counterparties, or the narrowness of the market. Currently available information on notional values of derivative instruments provides, at best, an incomplete indication of the aggregate size of the market for a particular derivative instrument or of an institution's participation in that market. An alternative, yet still imperfect, measure of market size would be the gross positive and gross negative market values of contracts by risk category or product. Such data would provide an indication of the economic or market value of the derivative instruments held by banks and securities firms in a particular market at a point in time and an institution's concentration in that market.

(b) Funding risk

35. Funding risk is the risk of derivatives activities placing adverse funding and cash flow pressures on an institution. Funding risk stemming from derivatives alone provides only a partial picture of an institution's liquidity position. In general, funding risk is best analyzed on an institution-wide basis across all financial instruments. However, it is also important for supervisors to understand the impact of derivatives on an institution's overall liquidity position.

36. Separate analysis of notional contract amounts of exchange-traded and OTC instruments (as described earlier) should augment supervisory awareness of funding risks, particularly given the requirements for margin and daily cash settlement of exchange-traded instruments and the resulting demands for liquidity that large positions in these instruments may entail. For example, significant positions in OTC contracts hedged with exchange-traded instruments could result in liquidity pressures arising from the daily margin and cash requirements of the exchange-traded products. Data on OTC contracts with collateral or other "margin-like" requirements may also be necessary for assessing liquidity risk. In addition, information about the notional amounts and expected cash flows of derivatives according to specified time intervals would be helpful in assessing funding risk.

37. Information on OTC contracts subject to "triggering agreements" provides further information about funding risk. Triggering agreements generally entail contractual provisions requiring the liquidation of the contract or the posting of collateral if certain events, such as a downgrade in credit rating, occur. Substantial positions in contracts with triggering agreements could increase funding risk by requiring the liquidation of

contracts or the pledging of collateral when the institution is experiencing financial stress. Accordingly, information on the total notional amount and replacement cost of OTC contracts (aggregated across products) with triggering provisions provides supervisors with important information about liquidity risk.

38. Supervisors should also consider evaluating information based on institutions' sensitivity analyses of the effect of adverse market developments on their funding requirements. This information would shed light on the potential for additional margin or collateral calls associated with exchange-traded and OTC derivatives positions due to changes in market variables such as interest rates and exchange rates.

3. Market risk

39. Market risk is the risk that the value of on- or off-balance-sheet positions will decline before the positions can be liquidated or offset with other positions. Supervisors should assess information on market risk by major categories of risk, such as interest rates, foreign exchange rates, equity prices and commodities. The market risk of derivatives is best assessed for the entire institution and should combine cash and derivatives positions. The assessment should cover all types of activities generating market risks. Supervisors may also consider breakdowns of positions at the level of individual portfolios, including, in the case of banks, trading and non-trading activities.

40. Supervisors will be interested in some or all of the following: position data that would allow independent supervisory assessment of market risk through the use of some supervisory model or monitoring criteria and data derived from an institution's own internal estimates of market risk.

41. For certain institutions, particularly those that are not major dealers, it may be appropriate to obtain position data (e.g. equities, debt securities, foreign exchange and commodities), which could be drawn from the framework of the Basle Committee's standardized approach for market risk, once adopted, or from other approaches adopted by national banking and securities supervisors. The collection of position data could be carried out at various levels of detail, depending on the nature and scope of the institution's trading and derivatives activities. The detail can range from a broad measure of exposure at the portfolio level to a finer disaggregation by instrument and maturity.

42. As an alternative or supplement to assessing position data, supervisors could evaluate available information on an institution's internal estimates of market risk. For some institutions, this information could be derived from their internal value-at-risk methodology, which involves the assessment of potential losses due to adverse movements in market prices

of a specified probability over a defined period of time. As an alternative to value-at-risk, supervisors may find it useful on a case-by-case basis to assess internally generated information on earnings-at-risk,[9] duration or gap analysis, scenario analyses, or any other approach that sheds light on an institution's market risk. Whatever the approach taken, supervisors should consider the measure of market risk exposure in the context of the institution's limit policies.

43. If a firm uses value-at-risk models for measuring market risk, the supervisor should evaluate in detail the methodology used, including its main parameters. Key parameters for evaluating value-at-risk estimates include: (1) the volatility and correlation assumptions of the model (either implied or historical volatilities), (2) the holding period over which the change in portfolio value is measured (e.g., two weeks), (3) the confidence interval used to estimate exposure (e.g., 99% of all outcomes) and (4) the historical sample period (e.g., one year or two years) over which risk factor prices are observed.

44. Value-at-risk measured solely at a point in time may not provide appropriate insights about market risk due to the speed with which positions in derivatives and other instruments can be altered. Such difficulties may be addressed by the use of summary statistics for the period over which the institution is reporting. For example, supervisors could require institutions to communicate information on the highest value-at-risk number measured during the reporting period, together with monthly or quarterly averages of value-at-risk exposures. By comparing end-of-period value-at-risk with these other measures, supervisors can better understand the volatility which has occurred in these measures during the period. Supervisors could also encourage or require institutions to convey comparisons of daily value-at-risk estimates with daily changes in actual portfolio value over a given period.[10] Internal models should be validated by comparing past estimates of risk with actual results and by assessing the models' major assumptions.

45. Institutions with significant trading books should subject their portfolios on a regular basis to stress tests using various assumptions and scenarios. These analyses of the portfolio under "worst case" scenarios should preferably be performed on an institution-wide basis and should

[9] Under mark-to-market accounting, value-at-risk will equal earnings-at-risk because changes in value are reflected in earnings. If accrual accounting is applied to certain positions, value-at-risk and earnings-at-risk will differ because all changes in value are not reflected in earnings.

[10] The report of the Euro-currency Standing Committee, a discussion paper entitled, *Public Disclosure of Market and Credit Risks by Financial Intermediaries*, issued in September 1994 (Fisher Report), discusses factors to consider in interpreting value-at-risk measures, among other topics.

include an identification of the major assumptions used. Quantitative information on the results of stress scenarios, which could be specified by supervisors or institutions themselves, coupled with qualitative analyses of the actions that management might take under particular scenarios, would be very useful for supervisory purposes. Examples of scenarios for interest rate risk include a parallel yield curve shift of a determined amount, a steepening or flattening of the yield curve, or a change of correlation assumptions.

46. To minimize burden, supervisory assessment of market risks should draw as much as possible on the information that institutions must collect for supervisory capital purposes. In the case of the banking sector, the Basle Committee's market risk capital requirements, once finalized and implemented, should serve as a basis for supervisory information on banks' market risks. In addition, bank supervisors should consider adopting some of the definitions of the market risk capital standards for reporting purposes, such as the definition of the trading book.

4. Earnings

47. As with cash market instruments, the profitability of derivatives activities and related on-balance-sheet positions are of interest to supervisors. The separate effects on income of trading activities and activities other than trading would also be of interest.

48. Accounting standards and valuation techniques differ from country to country and many member supervisors have little or no legal authority in this area. The Committees therefore recognize that earnings information identified under this framework may not be fully comparable across member countries.

(a) Trading purposes

49. Many sophisticated market participants view cash and derivative instruments as ready substitutes; their use of derivatives is complementary to cash instruments and positions in financial instruments are often managed as a whole. For supervisors to consider information that concentrates solely on derivatives and to omit similar data on cash instruments could be misleading. In this context, the decomposition of trading revenues (from cash and derivative instruments) according to broad risk classes—interest rate risk, foreign exchange risk, commodities and equities exposures, or other risks to the firm—without regard to the type of instrument that produced the trading income, may better describe the outcome of overall risk taking by the organization.

50. The systems of some banks or securities firms may not decompose trading revenues by broad categories of risk. Under these circumstances,

simplifying assumptions can be used to approximate this categorization of income. For example, if a particular department of an institution typically handles domestic bonds and related derivatives, it may be appropriate to consider trading gains and losses on these instruments as interest related income. Further, the income from complex instruments that are exposed to both foreign exchange and interest rate risk could be classified according to the primary attribute of the instrument (e.g. either as a foreign currency or an interest rate instrument).

51. Finer disaggregation of trading revenue within risk categories, for example, by origination revenue, credit spread revenue and other trading revenue could be useful in evaluating an organization's performance relative to its risk profile.[11] However, even those dealers with sophisticated information systems may not now be able to differentiate income beyond broad risk categories. As the analytical abilities and systems of market participants evolve, it may be desirable to consider supervisory information that differentiates between revenue earned from meeting customer needs and that earned from other sources. Furthermore, as market participants' systems evolve, it may be desirable for supervisors to evaluate information that differentiates between trading revenue earned from cash and derivatives positions in each broad risk category. As with cash instruments, a rapid build-up of material trading losses on derivative instruments may indicate deficiency in an institution's risk management systems and other internal controls that it should promptly evaluate and correct.

(b) Purposes other than trading

52. Information about derivatives held for purposes other than trading (end-user derivatives holdings) can also be useful to supervisors. For example, quantitative information that includes the effect on reported earnings of off-balance-sheet positions held by the organization to manage interest rate and other risks would be useful. When combined with information on other factors affecting net interest margins and interest rate sensitivity, this could provide insight into whether derivatives were being used to reduce interest rate risk or to take positions inconsistent with this objective.

(c) Identifying unrealised or deferred losses

53. As with cash instruments, any material build-up of unrealised losses or losses that have been realised but deferred by the institution may be

[11] As industry participants have recognized, trading revenue components may include: (1) origination revenue that results from the initial calculation of the market value of new transactions; (2) credit spread revenue that results from changes during the period in the unearned credit spread; and (3) other trading revenues resulting from changes in the value of the portfolio due to market movements and the passage of time.

an area of supervisory interest, particularly for banking supervisors. At a minimum, the detection of such losses, and particularly, an accumulation of such losses, should prompt supervisory inquiry. Derivative contracts with unrealised losses or deferred losses may reduce future earnings and capital positions when these losses are reflected in profits and losses for accounting purposes. Therefore, when unrealised losses or deferred amounts are material, it is important for supervisors to consider an institution's plans for reflecting these losses in their reported profits and losses for accounting purposes. Moreover, a rapid build-up of material unrealised or deferred losses may indicate a deficiency in an institution's internal controls and accounting systems that it should promptly evaluate or correct.

(d) Derivatives valuation reserves and actual credit losses

54. Supervisors should assess information on the valuation reserves that an institution has established for its derivatives activities and on any credit losses on derivative instrument that the institution has experienced during the period. In assessing these valuation reserves and any credit losses, it is important to understand the institution's risk management policies and valuation practices regarding derivatives. In addition, supervisors should determine how the institution reflected valuation reserves and credit losses in its balance sheet and income statement. Information on valuation reserves and the treatment of credit losses is useful in understanding how adverse changes in derivatives risks can affect an institution's financial condition and earnings.

Appendix II

6 Basle Committee Report on Risk Management Guidelines for Derivatives

[Excerpt]

I. Introduction and basic principles[1]

1. Derivatives instruments have become increasingly important to the overall risk profile and profitability of banking organizations throughout the world. Broadly defined, a derivatives instrument is a financial contract whose value depends on the values of one or more underlying assets or indexes. Derivatives transactions include a wide assortment of financial contracts, including forwards, futures, swaps and options. In addition, other traded instruments incorporate derivatives characteristics, such as those with imbedded options. While some derivatives instruments may have very complex structures, all of them can be divided into the basic building blocks of options, forward contracts or some combination thereof. The use of these basic building blocks in structuring derivatives instruments allows the transfer of various financial risks to parties who are more willing, or better suited, to take or manage them.

2. Derivatives contracts are entered into throughout the world on organized exchanges and through over-the-counter (OTC) arrangements. Exchange-traded contracts are typically standardized as to maturity, contract size and delivery terms. OTC contracts are custom-tailored to an institution's needs and often specify commodities, instruments and/or maturities that are not offered on any exchange. This document addresses banks' activities in both OTC and exchange-traded instruments.

3. Derivatives are used by banking organizations both as risk management tools and as a source of revenue. From a risk management perspective, they allow financial institutions and other participants to identify, isolate and manage separately the market risks in financial instruments and commodities. When used prudently, derivatives can offer managers efficient and effective methods for reducing certain risks through hedging. Derivatives may also be used to reduce financing costs and to increase the yield of certain assets. For a growing number of banking organizations,

[1]This text is reproduced with permission from the Basle Committee on Banking Supervision. It is an excerpt from ***Risk Management Guidelines for Derivatives*** (July 1994), prepared by the Basle Committee on Banking Supervision.

derivatives activities are becoming a direct source of revenue through "market-making" functions, position taking and risk arbitrage:

- *"market-making"* functions involve entering into derivatives transactions with customers and with other market-makers while maintaining a generally balanced portfolio with the expectation of earning fees generated by a bid/offer spread;
- *position-taking*, on the other hand, represents efforts to profit by accepting the risk that stems from taking outright positions in anticipation of price movements;
- *arbitrageurs* also attempt to take advantage of price movements, but focus their efforts on trying to profit from small discrepancies in price among similar instruments in different markets.

4. Participants in the derivatives markets are generally grouped into two categories based primarily on their motivations for entering into derivatives contracts. *End-users* typically enter into derivatives transactions to achieve specified objectives related to hedging, financing or position taking on the normal course of their business operations. A wide variety of business enterprises are end-users. They include, but are not limited to, a broad range of financial institutions such as banks, securities firms and insurance companies; institutional investors such as pension funds, mutual funds and specialized investment partnerships; and corporations, local and state governments, government agencies and international agencies.

5. *Intermediaries*, which are sometimes referred to as "dealers," cater to the needs of end-users by "making markets" in OTC derivatives instruments. In doing so, they expect to generate income from transaction fees, bid/offer spreads and their own trading positions. Important intermediaries, or derivative dealers, include major banks and securities firms around the world. As intermediaries, banks have traditionally offered foreign exchange and interest rate risk management products to their customers and generally view derivatives products as a financial risk management service.

6. The basic risks associated with derivatives transactions are not new to banking organizations. In general, these risks are credit risk, market risk, liquidity risk, operations risk and legal risk. Because they facilitate the specific identification and management of these risks, derivatives have the potential to enhance the safety and soundness of financial institutions and to produce a more efficient allocation of financial risks. However, since derivatives also repackage these basic risks in combinations that can be quite complex, they can also threaten the safety and soundness of institutions if they are not clearly understood and properly managed.

7. Recognizing the importance of sound risk management to the effective use of derivatives instruments, the following guidance is intended to highlight the key elements and basic principles of sound management practice for both dealers and end-users of derivatives instruments. These basic principles include:

1. Appropriate oversight by boards of directors and senior management;
2. Adequate risk management process that integrates prudent risk limits, sound measurement procedures and information systems, continuous risk monitoring and frequent management reporting; and,
3. Comprehensive internal controls and audit procedures.

II. Oversight of the risk management process

1. As is standard practice for most banking activities, an institution should maintain written policies and procedures that clearly outline its risk management guidance for derivatives activities. At a minimum these policies should identify the risk tolerances of the board of directors and should clearly delineate lines of authority and responsibility for managing the risk of these activities. Individuals involved in derivatives activities should be fully aware of all policies and procedures that relate to their specific duties.

Board of directors

2. The board of directors should approve all significant policies relating to the management of risks throughout the institution. These policies, which should include those related to derivatives activities, should be consistent with the organization's broader business strategies, capital strength, management expertise and overall willingness to take risk. Accordingly, the board should be informed regularly of the risk exposure of the institution and should regularly re-evaluate significant risk management policies and procedures with special emphasis placed on those defining the institution's risk tolerance regarding these activities. The board of directors should also conduct and encourage discussions between its members and senior management, as well as between senior management and others in the institution, regarding the institution's risk management process and risk exposure.

Senior management

3. Senior management should be responsible for ensuring that there are adequate policies and procedures for conducting derivatives operations on both a long-range and day-to-day basis. This responsibility includes ensuring that there are clear delineations of lines of responsibil-

ity for managing risk, adequate systems for measuring risk, appropriately structured limits on risk taking, effective internal controls and a comprehensive risk-reporting process.

4. Before engaging in derivatives activities, management should ensure that all appropriate approvals are obtained and that adequate operational procedures and risk control systems are in place. Proposals to undertake derivatives activities should include, as applicable:

- a description of the relevant financial products, markets and business strategies;
- the resources required to establish sound and effective risk management systems and to attract and retain professionals with specific expertise in derivatives transactions;
- an analysis of the reasonableness of the proposed activities in relation to the institution's overall financial condition and capital levels;
- an analysis of the risks that may arise from the activities;
- the procedures the bank will use to measure, monitor and control risks;
- the relevant accounting guidelines;
- the relevant tax treatment; and
- an analysis of any legal restrictions and whether the activities are permissible.

5. After the institution's initial entry into derivatives activities has been properly approved, any significant changes in such activities or any new derivatives activities should be approved by the board of directors or by an appropriate level of senior management, as designated by the board of directors.

6. Senior management should regularly evaluate the procedures in place to manage risk to ensure that those procedures are appropriate and sound. Senior management should also foster and participate in active discussions with the board, with staff of risk management functions and with traders regarding procedures for measuring and managing risk. Management must also ensure that derivatives activities are allocated sufficient resources and staff to manage and control risks.

7. As a matter of general policy, compensation policies—especially in the risk management, control and senior management functions—should be structured in a way that is sufficiently independent of the performance of trading activities, thereby avoiding the potential incentives for excessive risk taking that can occur if, for example, salaries are tied too closely to the profitability of derivatives.

Independent risk management functions

8. To the extent warranted by the bank's activities, the process of measuring, monitoring and controlling risk consistent with the established policies and procedures should be managed independently of individuals conducting derivatives activities, up through senior levels of the institution. An independent system for reporting exposures to both senior-level management and to the board of directors is an important element of this process.

9. The personnel staffing independent risk management functions should have a complete understanding of the risks associated with all of the bank's derivatives activities. Accordingly, compensation policies for these individuals should be adequate to attract and retain personnel qualified to assess these risks.

III. The risk management process

1. The primary components of a sound risk management process are the following: a comprehensive risk measurement approach; a detailed structure of limits, guidelines and other parameters used to govern risk taking; and a strong management information system for controlling, monitoring and reporting risks. These components are fundamental to both derivatives and non-derivatives activities alike. Moreover, the underlying risks associated with these activities, such as credit, market, liquidity, operations and legal risk, are not new to banking, although their measurement and management can be more complex. Accordingly, the process of risk management for derivatives activities should be integrated into the institution's overall risk management system to the fullest extent possible using a conceptual framework common to the institution's other activities. Such a common framework enables the institution to manage its risk exposure more effectively, especially since the various individual risks involved in derivatives activities can, at times, be interconnected and can often transcend specific markets.

2. As is the case with all risk-bearing activities, the risk exposures an institution assumes in its derivatives activities should be fully supported by an adequate capital position. The institution should ensure that its capital position is sufficiently strong to support all derivatives risks on a fully consolidated basis and that adequate capital is maintained in all group entities engaged in these activities.

Risk measurement

3. An institution's system for measuring the various risks of derivatives activities should be both comprehensive and accurate. Risk should be

measured and aggregated across trading and non-trading activities on an institution-wide basis to the fullest extent possible.

4. While the use of a single prescribed risk measurement approach for management purposes may not be essential, the institution's procedures should enable management to assess exposures on a consolidated basis. Risk measures and the risk measurement process should be sufficiently robust to reflect accurately the multiple types of risks facing the institution. Risk measurement standards should be understood by relevant personnel at all levels of the institution—from individual traders to the board of directors—and should provide a common framework for limiting and monitoring risk taking activities.

5. With regard to dealer operations, the process of marking derivatives positions to market is fundamental to measuring and reporting exposures accurately and on a timely basis. An institution active in dealing foreign exchange, derivatives and other traded instruments should have the ability to monitor credit exposures, trading positions and market movements at least daily. Some institutions should also have the capacity, or at least the goal, of monitoring their more actively traded products on a real-time basis.

6. Analyzing stress situations, including combinations of market events that could affect the banking organization, is also an important aspect of risk measurement. Sound risk measurement practices include identifying possible events or changes in market behavior that could have unfavorable effects on the institution and assessing the ability of the institution to withstand them. These analyses should consider not only the likelihood of adverse events, reflecting their probability, but also "worst case" scenarios. Ideally, such worst case analysis should be conducted on an institution-wide basis by taking into account the effect of unusual changes in prices or volatilities, market illiquidity or the default of a large counterparty across both the derivatives and cash trading portfolios and the loan and funding portfolios.

7. Such stress tests should not be limited to quantitative exercises that compute potential losses or gains. They should also include more qualitative analyses of the actions management might take under particular scenarios. Contingency plans outlining operating procedures and lines of communication, both formal and informal, are important products of such qualitative analyses.

Limiting risks

8. A sound system of integrated institution-wide limits and risk taking guidelines is an essential component of the risk management process. Such a system should set boundaries for organizational risk taking and

should also ensure that positions that exceed certain predetermined levels receive prompt management attention. The limit system should be consistent with the effectiveness of the organization's overall risk management process and with the adequacy of its capital position. An appropriate limit system should permit management to control exposures, to initiate discussion about opportunities and risks and to monitor actual risk taking against predetermined tolerances, as determined by the board of directors and senior management.

9. Global limits should be set for each major type of risk involved in an institution's derivatives activities. These limits should be consistent with the institution's overall risk measurement approach and should be integrated to the fullest extent possible with institution-wide limits on those risks as they arise in all other activities of the institution. Where appropriate, the limit system should provide the capability to allocate limits down to individual business units.

10. If limits are exceeded, such occurrences should be made known to senior management and approved only by authorized personnel. These positions should also prompt discussions about the consolidated risk taking activities of the institution or the unit conducting the derivatives activities. The seriousness of limit exceptions depends in large part upon management's approach toward setting limits and on the actual size of individual and organizational limits relative to the institution's capacity to take risk. An institution with relatively conservative limits may encounter more exceptions to those limits than an institution with less restrictive limits.

Reporting

11. An accurate, informative and timely management information system is essential to the prudent operation of derivatives activities. Accordingly, the quality of the management information system is an important factor in the overall effectiveness of the risk management process. The risk management function should monitor and report its measures of risks to appropriate levels of senior management and to the board of directors. In dealer operations, exposures and profit and loss statements should be reported at least daily to managers who supervise but do not, themselves, conduct those activities. More frequent reports should be made as market conditions dictate. Reports to other levels of senior management and the board may occur less frequently, but the frequency of reporting should provide these individuals with adequate information to judge the changing nature of the institution's risk profile.

12. Management information systems should translate the measured risk for derivatives activities from a technical and quantitative format to one that can be easily read and understood by senior managers and direc-

tors, who may not have specialized and technical knowledge of derivatives products. Risk exposures arising from various derivatives products should be reported to senior managers and directors using a common conceptual framework for measuring and limiting risks.

Management evaluation and review

13. Management should ensure that the various components of the institution's risk management process are regularly reviewed and evaluated. This review should take into account changes in the activities of the institution and in the market environment, since the changes may have created exposures that require additional attention. Any material changes to the risk management system should also be reviewed.

14. The risk management functions should regularly assess the methodologies, models and assumptions used to measure risk and to limit exposures. Proper documentation of these elements of the risk measurement system is essential for conducting meaningful reviews. The review of limit structures should compare limits to actual exposures and should also consider whether existing measures of exposure and limits are appropriate in view of the institution's past performance and current capital position.

15. The frequency and extent to which an institution should reevaluate its risk measurement methodologies and models depends, in part, on the specific risk exposures created by their derivatives activities, on the pace and nature of market changes and on the pace of innovation with respect to measuring and managing risks. At a minimum, an institution with significant derivatives activities should review the underlying methodologies of its models at least annually—and more often as market conditions dictate—to ensure they are appropriate and consistent. Such internal evaluations may, in many cases, be supplemented by reviews by external auditors or other qualified outside parties, such as consultants who have expertise with highly technical models and risk management techniques. Assumptions should be evaluated on a continual basis.

16. The institution should also have an effective process to evaluate and review the risks involved in products that are either new to it, or new to the marketplace and of potential interest to the institution. It should also introduce new products in a manner that adequately limits potential losses and permits the testing of internal systems. An institution should not become involved in a product at significant levels until senior management and all relevant personnel (including those in risk management, internal control, legal, accounting and auditing) understand the product and are able to integrate the product into the institution's risk measurement and control systems.

Appendix II

7 OCC Banking Circular No. 277: Risk Management of Financial Derivatives

Risk Management of Financial Derivatives[1]

[Excerpt]

GUIDANCE

A. Senior Management and Board Oversight

National banks that engage in derivatives activities should have effective senior management supervision and oversight by the Board of Directors to ensure that such activities are conducted in a safe and sound manner and are consistent with the Board of Director's overall risk management philosophy and the bank's business strategies.

1. Written Policies and Procedures

A bank should have comprehensive written policies and procedures to govern its use of derivatives. Senior management should review the adequacy of these policies and procedures, in light of the bank's activities and market conditions, at least annually. Appropriate governance by the Board of Directors should include an initial endorsement of significant policies (and changes, as applicable) and periodic approval thereafter, as appropriate, considering the scope, size, and complexity of the bank's derivatives activities.

2. General Risk Monitoring and Control

Senior management of each national bank engaging in derivatives transactions should establish an independent unit or individual responsible for measuring and reporting risk exposures. That responsibility should include monitoring compliance with policies and risk exposure limits.

3. Risk Management Systems

National banks engaged in financial derivatives transactions should have comprehensive risk management systems that are commensurate

---

[1] This text is dated October 27, 1993. It comprises excerpts from the banking circular prepared by the Office of the Comptroller of the Currency.

with the scope, size, and complexity of their activities and the risks they assume. Such systems must ensure that market factors affecting risk exposures are adequately measured, monitored, and controlled. These factors include changes in interest and currency exchange rates, commodity and equity prices and their associated volatilities, changes in the credit quality of counterparties, changes in market liquidity, and the potential for major market disruptions. Risk management procedures also should adequately control potential losses arising from system deficiencies.

4. Audit Coverage

National banks should have audit coverage of their financial derivatives activities adequate to ensure timely identification of internal control weaknesses and/or system deficiencies. Such audit coverage should be provided by competent professionals who are knowledgeable of the risks inherent in the financial derivatives transactions.

B. Market Risk Management

1. Dealers and Active Position-Takers

National banks whose financial derivatives activities involve dealing or active position-taking should have risk measurement systems that can quantify risk exposures arising from changes in market factors. Those systems should be structured to enable management to initiate prompt remedial action. The systems also should facilitate stress testing and enable management to assess the potential impact of various changes in market factors on earnings and capital.

2. Limited End-Users

A bank whose derivatives activities are limited in volume and confined to risk management activities may need less sophisticated risk measurement systems than those required by a dealer or active position-taker. Senior management at such a bank should ensure that all significant risks arising from their transactions can be quantified, monitored, and controlled. At a minimum, risk management systems should evaluate the possible impact on the bank's earnings and capital which may result from adverse changes in interest rates and other market conditions that are relevant to the bank's risk exposure and the effectiveness of financial derivatives transactions in the bank's overall risk management.

C. Credit Risk Management

Credit risk management should parallel the prudent controls expected in traditional lending activities. Policies and procedures should be formalized to address concerns such as significant counterparty exposures, concentrations, credit exceptions, risk ratings, nonperforming contracts, and

allowance allocations. Timely, meaningful reports should be generated and distributed consistent with policy and procedure requirements.

1. Credit Approval Function

To ensure safe and sound management of derivatives credit risk exposures, bank management should make sure that credit authorizations are provided by personnel independent of the trading unit. Credit officers should be qualified to identify and assess the level of credit risk inherent in a proposed derivatives transaction. Approving officers also should be able to identify if a proposed derivatives transaction is consistent with a counterparty's policies and procedures with respect to derivatives activities, as they are known to the bank.

2. Pre-Settlement Risk

The system a bank uses to quantify pre-settlement credit risk exposure should take into account current exposure ("mark-to-market") as well as potential credit risk due to possible future changes in applicable market rates or prices ("add-on"). That system should use a reliable source for determining the credit risk factor used to calculate the credit risk add-on.

3. Settlement Risk

A bank's system for managing counterparty credit risk should address settlement risk.

4. Credit Risk Monitoring

Credit risk monitoring should be independent of the units that create financial derivatives exposures. This risk monitoring unit should be responsible for producing and distributing timely, accurate information about credit exposures such as line usage, concentrations, credit quality, limit exceptions, and significant counterparty exposures. Credit exposure reports should provide aggregate information about the bank's credit risk to a given counterparty (including products such as loans, securities underwritings, and other traded products). The risk monitoring unit should ensure that appropriate levels of senior management and the Board of Directors receive relevant information about credit exposure arising from derivatives activities on a periodic and timely basis.

D. Liquidity Risk Management

Bank management should establish effective controls over the liquidity exposure arising from financial derivatives activities. Key principles in the governance and management of this risk are diversification and communication.

1. Market/Product Liquidity Risk

Exposure to market/product liquidity risk should be formally addressed within market risk limits. Diversification policies specifically addressing known or potential liquidity problems also should be implemented. Limits should be designed to trigger management action and control loss. Quality and timely communication also should be an integral part of a bank's risk management culture.

2. Cash Flow/Funding Liquidity Risk

A bank should have liquidity policies to formally govern its exposure to cash flow gaps (from intermediate payments or settlements) arising from financial derivatives activities.

3. Early Termination Arrangements and Credit Enhancements

Policies should control the bank's exposure arising from early termination arrangements, as well as collateralization or other credit enhancements.

4. Monitoring

Banks should have management information systems that permit daily monitoring of liquidity positions relative to limits. These reports should be prepared by an area or employee(s) independent of the trading unit.

E. Operations and Systems Risk Management

The Board of Directors and senior management should ensure the proper dedication of resources (financial and personnel) to support operations and systems development and maintenance. The operations unit for financial derivatives activities, consistent with other trading and investment activities, should report to an independent unit, and should be managed independently of the business unit. The sophistication of the systems support and operational capacity should be commensurate with the size and complexity of the derivatives business activity.

1. Quality of Personnel

Senior management should recognize the need for, and devote appropriate resources to, employing knowledgeable and experienced personnel in the operations area.

2. Systems

Systems design and needs may vary according to the size and complexity of a bank's financial derivatives business. However, each system should provide for accurate and timely processing and allow for proper risk exposure monitoring.

3. Segregation of Duties

Segregation of operational duties, exposure reporting, and risk monitoring from the business unit is critical to proper internal control.

4. Valuation Issues

Banks that engage in financial derivatives activities should ensure that the methods they use to value their derivatives positions are appropriate and that the assumptions underlying those methods are reasonable.

5. Documentation

Bank management should ensure a mechanism exists whereby financial derivatives contract documentation is confirmed, maintained, and safeguarded. Documentation exceptions should be properly monitored and resolved.

F. Legal Issues

Prior to engaging in derivatives transactions, a national bank should reasonably satisfy itself that its counterparties have the legal, and any necessary regulatory, authority to engage in those transactions. In addition to determining the authority of a counterparty to enter into a derivatives transaction, a national bank also should reasonably satisfy itself that the terms of any contract governing its derivatives with a counterparty are legally sound.

1. Bilateral Netting

In order to reduce counterparty credit exposure, a national bank should use master close-out netting agreements with its counterparties to the broadest extent *legally enforceable*, including in any possible insolvency proceedings of such counterparties. However, the reliance upon such agreements where the enforceability of such agreements against a particular counterparty has not been legally established should be considered carefully and will be scrutinized closely by the OCC.

2. Multilateral Netting

A national bank should determine credit and liquidity exposure and account for financial derivatives transactions on a multilaterally netted basis only if cleared through a clearinghouse, organization, or facility that meets the conditions set forth in the *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of 10 Countries*, Bank for International Settlements, Nov. 1990 ("Lamfalussy Report").

3. Physical Commodity Transactions

National banks may engage in physical commodity transactions in order to manage the risks arising out of physical commodity financial derivatives transactions if they meet the following conditions:

- Any physical transactions supplement the bank's existing risk management activities, constitute a nominal percentage of a bank's risk management activities, are used only to manage risk arising from otherwise permissible (customer-driven) banking activities, and are not entered into for speculative purposes; and
- Before entering into any such physical transactions, the bank has submitted a detailed plan for the activity to the OCC and the plan has been approved.

G. Capital Adequacy

The Board of Directors should ensure that the bank maintains sufficient capital to support the risk exposures (e.g., market risk, credit risk, liquidity risk, operation and systems risk, etc.) that may arise from its derivatives activities. Significant changes in the size or scope of a bank's activities should prompt an analysis of the adequacy of the amount of capital supporting those various activities by senior management and/or the Board of Directors. This analysis should be approved by the Board of Directors and be available for bank examiner review. In addition to internal reviews of capital adequacy, senior management should ensure that the bank meets all regulatory capital standards for financial derivatives activities.

Appendix II

8 Principles and Practices for Wholesale Financial Market Transactions

Introduction[1]

These Principles and Practices for Wholesale Financial Market Transactions are the result of a joint effort by several groups that represent participants in the over-the-counter financial markets. These Principles were prepared in order to confirm the relationship between Participants and to articulate a set of best practices with respect to over-the-counter financial markets transactions between Participants.

Representatives of the Emerging Markets Traders Association, the Foreign Exchange Committee of the Federal Reserve Bank of New York, the International Swaps and Derivatives Association, the New York Clearing House Association, the Public Securities Association and the Securities Industry Association participated in the preparation of the Principles. The preparation of the Principles was coordinated by the Federal Reserve Bank of New York.

1. PURPOSE OF PRINCIPLES AND PRACTICES

1.1 Applicability

These Principles and Practices for Wholesale Financial Market Transactions (the "Principles") are intended to provide guidance for the conduct of wholesale transactions in the over-the-counter financial markets between Participants ("Transactions").

"Participant" means any corporation, partnership, trust, government or other entity that engages regularly in one or more types of Transactions. The term "counterparty" as used in the Principles means a Participant that is the other party to a Transaction with a Participant.

The Principles reflect principles and practices in the United States of America and may not reflect principles and practices in other countries.

[1] This text is reproduced with permission from the drafting group. This undated text was released on August 17, 1995.

1.2 Nature of Principles

The Principles confirm the arm's-length nature of Transactions and describe the assumptions that Participants may make about each other. The Principles also articulate a set of best practices that Participants should aspire to achieve in connection with their Transactions. It is intended that the Principles (especially those contained in Section 3) will continue to evolve over time as business practices change. The Principles do not create any legally enforceable obligations, duties, rights or liabilities.

Adherence to the Principles is strictly voluntary. A Participant may implement the Principles as it deems appropriate. Any policies or procedures implemented or other actions taken by a Participant based on the Principles should be appropriate for the size, nature and complexity of the Participant and its Transactions as well as its business activities generally.

It should not be assumed that an entity that is within the definition of Participant necessarily adheres to the Principles. Nevertheless, because the Principles confirm the nature of the relationship between Participants, an entity that is within the definition of Participant should be aware that Participants will make certain assumptions when entering into Transactions with that entity.

1.3 Supplementary Nature of Principles

The Principles are intended to supplement, and are not intended to replace or modify, applicable statutes, governmental regulations, exchange, board of trade or self-regulatory organization rules and industry practices (including those embodied in applicable codes of conduct).

2. PARTICIPANTS—FINANCIAL RESOURCES

2.1 Financial Resources

A Participant should maintain adequate financial resources, including capital, liquidity or other sources of support, to manage the material risks associated with its Transactions and meet its Transaction commitments.

3. PARTICIPANTS—POLICIES AND PROCEDURES

3.1 Policies and Procedures

With respect to policies and procedures of the types identified in the Principles, a Participant should have policies approved by its board of directors, a committee thereof or an appropriate level of senior management. An appropriate level of senior management should approve con-

trols and procedures to implement these policies. All policies, controls and procedures should be appropriate to the size, nature and complexity of the Participant and its Transactions, and should be reviewed as business and market circumstances change.

3.2 Supervision and Training of Employees

A Participant should maintain internal policies and procedures for supervising and training appropriate officers, employees and representatives of the Participant with respect to conduct related to Transactions.

3.3 Control and Compliance

A Participant should maintain and enforce internal control and compliance procedures designed so that its Transactions are conducted in accordance with applicable legal and regulatory requirements, internal policies and any specific requirements contained in any agreements applicable to its Transactions.

3.4 Risk Management

A Participant should maintain (i) policies and procedures that clearly delineate lines of responsibility for managing market, credit and other risks, (ii) adequate systems for measuring risks, including, where appropriate, systems for developing stress scenarios to measure the impact of market conditions that might reduce liquidity or cause extraordinary changes in price or volatility, (iii) appropriately structured limits on risk taking, (iv) policies and procedures designed for comprehensive and timely risk reporting, and (v) policies and procedures for reviewing the adequacy of internal measures of credit risk, market risk and valuation.

3.5 Independent Risk Monitoring

A Participant should have knowledgeable individuals responsible for risk monitoring and control who are independent of the individuals that conduct the Transactions that create the risk exposure.

3.6 Valuation

3.6.1 Valuation of Transactions

A Participant should maintain policies and procedures for the valuation of Transactions at intervals appropriate for the type of Transaction in question, regardless of the accounting methodology employed by the Participant. These policies and procedures should address the specific methodology used for valuation, including as appropriate the use of market or model based valuations with reserves and adjustments.

3.6.2 Obtaining External Valuations

If a Participant does not have the internal capability to value a Transaction and a price or market valuation of a Transaction is not publicly available or otherwise readily ascertainable, then the Participant should (i) ascertain the availability of external valuations (which may include valuations from its counterparty) prior to entering into the Transaction and (ii) obtain an external valuation of the Transaction at intervals appropriate for the type of Transaction in question.

When a Participant requests an external valuation for a Transaction, the Participant should clearly state the desired characteristics of the requested valuation (*e.g.*, mid-market, indicative or firm price).

3.6.3 Evaluating External Valuations

In assessing any external valuation received, it is essential that the Participant consider the circumstances in which the valuation was provided, including criteria such as whether the party providing the valuation is a counterparty to the Transaction, the time frame within which the valuation was provided and whether the party supplying the valuation was compensated for its services. Participants should understand that a valuation of a particular Transaction may include adjustments for, among other factors, credit spreads, cost of carry and use of capital and profit, and may not be representative of either (i) the valuation used by a counterparty for internal purposes or (ii) other market or model based valuations.

3.6.4 Providing Valuations to Other Participants

Entering into a Transaction does not obligate a Participant to provide valuations of that Transaction to its counterparty. However, if a Participant does provide valuations of Transactions, it should maintain policies and procedures concerning the provision of valuations. Such policies and procedures should require the Participant to clearly state the characteristics of any valuation provided (*e.g.*, mid-market, indicative or firm price). In those markets with specific conventions regarding valuations, Participants should supply valuations using those conventions, unless otherwise agreed.

3.7 Credit Risk

Before entering into a Transaction involving credit exposure to a counterparty, a Participant should assess its counterparty's ability to meet its payment obligations.

As credit relationships depend upon the existence of a legal relationship between parties, Participants should recognize situations where special

steps may be necessary to assure that Transactions are enforceable against the party on whose credit the Participant is relying, particularly when dealing through third parties such as agents, brokers or investment advisors acting for undisclosed principals.

3.8 Legal Capacity and Authority to Transact

Before entering into a Transaction, a Participant should take measures reasonable under the circumstances to satisfy itself that its counterparty has the legal capacity and authority to enter into the Transaction. A Participant should recognize that Transactions with governmental units and regulated counterparties (such as depository institutions, mutual funds, pension plans, trusts and insurance companies) may require additional scrutiny to establish the scope of the counterparty's legal capacity and authority. Special scrutiny also should be given to the scope of a third party agent's authority to act for its principal.

4. RELATIONSHIPS BETWEEN PARTICIPANTS

4.1 Fair Dealing and Professional Standards

A Participant should act honestly and in good faith when marketing, entering into, executing and administering Transactions. A Participant should act in a manner designed to promote public confidence in the wholesale financial markets. In addition, a Participant should show its counterparties professional courtesy and consideration.

4.2 Relationships with Counterparties

4.2.1 Decision-Making Capability

A Participant should satisfy itself that it has the capability (internally or through independent professional advice) to understand and make independent decisions about its Transactions. That capability includes the experience, knowledge and ability to analyze the tax and accounting treatment as well as the legal, credit, market and liquidity risks of each Transaction. Absent a written agreement to the contrary, a Participant should expect that its counterparty will assume that the Participant has the capability to understand and make independent decisions about its Transactions and will act accordingly.

4.2.2 Reliance on Investment Advice

The character and level of risk that is desirable for a particular Participant is a business judgment that is appropriately made by the Participant's governing body or management, in accordance with any applicable statutory or regulatory constraints, based on an evaluation of the totality of its particular circumstances and objectives.

A Participant may communicate to its counterparty economic or market information relating to Transactions and trade or hedging ideas or suggestions. All such communications (whether written or oral) should be accurate and not intentionally misleading. Absent a written agreement or an applicable law, rule or regulation that expressly imposes affirmative obligations to the contrary, a counterparty receiving such communications should assume that the Participant is acting at arm's length for its own account and that such communications are not recommendations or investment advice on which the counterparty may rely.

In any case where a Participant does not wish to make independent investment decisions regarding a Transaction and instead wishes to rely on a counterparty's communications as recommendations or investment advice, the Participant should, prior to entering into a Transaction with that counterparty involving such reliance, (i) put its counterparty on notice in writing that it is relying on the counterparty, (ii) obtain the counterparty's agreement in writing to do business on that basis, and (iii) provide the counterparty with accurate information regarding its financial objectives and the size, nature and condition of its business sufficient to provide such recommendations or investment advice. The extent of the counterparty's obligations to provide recommendations and investment advice then will be determined by that written agreement and any applicable law, rule or regulation that imposes affirmative obligations on the counterparty. Certain laws, rules or regulations expressly provide that, in some situations, an oral agreement or the facts and circumstances of a relationship alone may give rise to an advisory or fiduciary relationship, in some cases even in the presence of a written agreement purporting to negate such a relationship. Nonetheless, to avoid misunderstandings and disputes, the steps outlined above should be followed.

4.2.3 Transaction Information

A Participant should ensure that it identifies and reaches agreement on all material terms and conditions of each Transaction it enters into. In some cases it may be useful for the parties to exchange a written outline of the principal terms and conditions of a Transaction prior to its execution. A Participant should either ask questions and request additional information or seek independent professional advice when it does not have a full understanding of either the risks involved in a Transaction or the fit between a Transaction and its desired risk profile. A counterparty should answer such questions and respond to such requests for additional information in good faith, and the information provided should be accurate and not intentionally misleading. A Participant should expect that, if it does not expressly ask questions or request additional information with respect to a Transaction, its counterparty will assume that the Participant

understands the Transaction and has all the information it needs for its decision-making process.

4.2.4 Other Activities of Counterparties

A Participant should be aware that in the over-the-counter financial markets it may be customary for a counterparty to (i) take positions in instruments that are identical or economically related to a Transaction that has been or will be entered into with the Participant, or (ii) have commercial relationships with the issuer of an instrument underlying a Transaction that has been or will be entered into with the Participant.

4.2.5 Role as Agent or Broker

A Participant that represents itself as generally acting as a "broker" in Transactions should act only as agent for both parties or (in those markets where it is customary to do so) as riskless principal, unless it discloses clearly to all parties before executing a Transaction that it is acting in another capacity.

A Participant that represents itself as generally acting as a principal may on occasion agree to act as an agent for a counterparty, to assist the counterparty to execute a Transaction with other Participants on a "best execution" basis or at a specified level, or to effect a Transaction directly if and when the Participant is prepared to do so at a specified level. A Participant acting as an agent should avoid misusing its knowledge of the terms on which the counterparty is prepared to execute a Transaction to take unfair advantage of the counterparty.

A Participant should be aware that its agent may be engaging in other activities as described above in Section 4.2.4.

4.3 Confidentiality

A Participant expects that its involvement in a Transaction will be handled in confidence by its counterparty. Accordingly, a Participant should not, except with express permission, disclose or discuss, or request that others disclose or discuss, information relating to its counterparty's involvement in a Transaction except to the extent required by law or required or requested by a regulatory authority.

5. CONSIDERATIONS RELATING TO RELATIONSHIPS BETWEEN PARTICIPANTS

5.1 Introduction

A Participant (particularly one that is holding itself out as a dealer in a particular wholesale financial instrument) should maintain policies and procedures that identify and address circumstances that can lead to uncer-

tainties, misunderstandings or disputes with the potential for relationship, reputational or litigation risk. A Participant should consider including in such policies and procedures provisions designed to address the particular circumstances described in this Section 5. Maintaining and complying with such policies and procedures should be regarded as steps taken by the Participant for its own protection. Accordingly, neither the maintenance nor compliance with such policies and procedures should be construed as giving rise to duties to others.

5.2 Counterparty Decision-Making Capability

A Participant may wish to evaluate (based upon information in its possession) its counterparty's capability (internally or through independent professional advice) to understand and make independent decisions about the terms and conditions of its Transactions. A Participant may, without limitation, consider the following factors in evaluating a counterparty's capability: the nature of the counterparty's business; the financial size and condition of the counterparty; the counterparty's prior dealings or experience in Transactions; and the nature, complexity and risks of a proposed Transaction. A Participant should be aware that if it holds itself out as a dealer for a certain type of Transaction, other Participants will assume that it has the capability to understand and make independent decisions regarding that type of Transaction.

A Participant may wish to maintain policies and procedures for identifying (based on information in the possession of the representative of the Participant executing the Transaction on the Participant's behalf) and addressing exceptional situations (which may pose relationship, reputational or litigation risks to the Participant) where its counterparty either (i) does not have the capability (internally or through independent professional advice) to understand and make independent decisions regarding a particular Transaction or a type of Transaction being proposed by the Participant or (ii) has the capability to understand and make independent decisions regarding a Transaction, but where (a) the amount of risk to the counterparty involved in the Transaction appears to be clearly disproportionate in relation to the size, nature and condition of the counterparty's business or (b) the counterparty appears to assume incorrectly that it may rely on the Participant for recommendations or investment advice.

A Participant may wish to consider taking such steps, if any, as it may deem appropriate in the circumstances to address these types of exceptional situations, including, without limitation, (i) providing or obtaining additional information to or from the counterparty, (ii) involving additional qualified personnel internally, (iii) involving additional qualified personnel of the counterparty, (iv) entering into a written agreement specifying the nature of the relationship or (v) not entering into the par-

ticular Transaction or type of Transaction with that counterparty. This list of steps to consider for exceptional situations is neither exhaustive nor mandatory because any appropriate response will be based upon the facts and circumstances of a specific situation.

5.3 Notifying Counterparties of Nature of Relationship

A Participant may wish to inform some or all of its own counterparties of the nature of the relationships between Participants. Such information may, without limitation, take the form of (i) communications to a counterparty that are designed to put the counterparty on notice about the Participant's assumptions regarding the counterparty's capability to understand and make independent decisions and non-reliance concerning Transactions with the Participant (which communications may include sending a copy of the Principles to the counterparty), or (ii) representations or disclosures to be acknowledged by a counterparty that are designed to confirm that the Participant's assumptions regarding the counterparty's capability to understand and make independent decisions and non-reliance concerning Transactions with the Participant are correct.

5.4 Providing Additional Information to Counterparties

For a Transaction in which the payment formula is particularly complex or which includes a significant leverage component, a Participant may wish to assist a counterparty in its decision-making process by providing more information (such as loss scenarios) to a counterparty than is typically provided for other types of Transactions. Where loss scenarios are part of the information voluntarily provided to a counterparty, or where loss scenarios are prepared at a counterparty's request and the counterparty does not stipulate some or all of the assumptions to be used in making the calculations, the Participant should attempt in good faith to use assumptions that provide information that is reasonable under the circumstances.

6. MECHANICS OF TRANSACTIONS

6.1 When Transactions are Binding

A Transaction should be considered final and binding when entered into in accordance with applicable market practice, whether by oral, written or electronic means.

6.2 Confirmations

Transactions should be confirmed as soon as possible and in accordance with applicable market practice. For most types of Transactions, a confirmation (whether sent by mail, telex, facsimile, electronic or other means) provides a necessary final safeguard against errors. All confirma-

tions should be dispatched promptly by one or both parties and reviewed carefully by the receiving party, even when oral checks of the Transactions have been undertaken. The dispatch and checking of confirmations also should be carried out or reviewed independently from those who conduct the Transactions.

6.3 Payment and Settlement Instructions

A Participant should provide its counterparty with standing payment and settlement instructions, and any modifications to those standing instructions should be communicated as quickly as possible to facilitate prompt settlement of Transactions.

6.4 Documentation

A Participant should use, to the greatest extent practicable, standardized or master agreements or comparable arrangements that apply to multiple Transactions, in order to provide standardized terms governing Transactions and to provide for the netting or offset of credit exposures and payment obligations. A Participant should review and where appropriate modify the documentation it uses in connection with Transactions periodically in light of changes in market practice or law.

6.5 Complaints and Settlement of Differences

A Participant should notify its counterparty promptly of any dispute or complaint involving a Transaction in order to mitigate any damages to itself or its counterparty. A Participant should attempt to resolve promptly and fairly any such dispute or complaint. A Participant should ensure that all complaints involving Transactions are promptly and fairly investigated, wherever practicable, by employees or representatives of the Participant who were not directly involved with the disputed Transaction. Such investigations should be construed as an act of prudence to reduce the risk of loss resulting from the dispute, and not as an admission of liability by the Participant.

In addition, upon receiving information that a complaint or dispute involving a Transaction may create market exposure, the Participant should consider all available methods to reduce potential losses from that exposure. Any such steps taken should be construed as an act of prudence and not an admission of liability by the Participant.

7. STANDARDS FOR TRANSACTIONS

7.1 Misuse of Market Terminology and Conventions

Traders, brokers, and other employees or representatives of a Participant should use clear and unambiguous language when negotiating

Transactions. Recognizing that each type of Transaction may have its own unique terminology, definitions and calculations, a Participant should, prior to engaging in a Transaction, familiarize itself with that type of Transaction's terminology and conventions, and, where necessary, inform its personnel of differences in terminology, conventions and specific terms that may be particularly susceptible to misinterpretation. In addition, no Participant should abuse deliberately market procedures or conventions to obtain an unfair advantage over, or to unfairly prejudice, its counterparties.

7.2 Manipulative Practices

A Participant should not engage in any trading practices that constitute fraudulent, deceptive or manipulative acts or practices under applicable laws and regulations.

7.3 Bribes and Outside Fees and Commissions

No employee or representative of a Participant should offer or solicit explicit inducements to or from employees or representatives of other institutions in exchange for conducting business. It is recognized, however, that entertainment and gifts in reasonable amounts are offered and accepted in the ordinary course of business, and do not necessarily constitute inducements. A Participant should maintain policies and procedures that provide guidance on the provision and receipt of entertainment and gifts by staff.

7.4 Rumors and False Information

A Participant should not spread any rumors or misinformation that the Participant knows or believes to be false or misleading. In addition, a Participant should not disseminate any information that falsely states or implies governmental approval of any institution or Transaction.

7.5 Money Laundering and Other Criminal Activities

A Participant should take measures designed to satisfy itself that its Transactions are not being used to facilitate money laundering or other criminal activities.

Appendix II

9 Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries

[Excerpt][1]

Minimum standards for the design and operation of cross-border and multi-currency netting and settlement schemes

I. Netting schemes should have a well-founded legal basis under all relevant jurisdictions.

II. Netting scheme participants should have a clear understanding of the impact of the particular scheme on each of the financial risks affected by the netting process.

III. Multilateral netting systems should have clearly defined procedures for the management of credit risks and liquidity risks which specify the respective responsibilities of the netting provider and the participants. These procedures should also ensure that all parties have both the incentives and the capabilities to manage and contain each of the risks they bear and that limits are placed on the maximum level of credit exposure that can be produced by each participant.

IV. Multilateral netting systems should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single net-debit position.

V. Multilateral netting systems should have objective and publicly disclosed criteria for admission which permit fair and open access.

VI. All netting schemes should ensure the operational reliability of technical systems and the availability of back-up facilities capable of completing daily processing requirements.

[1] This text is reproduced with permission from the Bank for International Settlements. These minimum standards, known as the Lamfalussy Standards, are from the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries, *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* 26 (November 1990).

Appendix II

10 Report on Netting Schemes Prepared by the Group of Experts on Payment Systems of the Central Banks of the Group of Ten Countries

[Excerpt][1]

. . . the Payments Group believes that certain general conclusions can be drawn with respect to the allocation of credit and liquidity risks that are produced by different institutional forms of netting. Thus, assuming the legal enforceability of netting agreements, the Payments Group believes that arrangements which net outstanding financial or payment obligations can be ranked as follows, in comparison with the benchmark case, where no netting takes place:

(i) bilateral position netting reduces liquidity risks to counterparties, and perhaps others such as correspondent banks, relative to the case of no netting; but it leaves counterparty credit risk unchanged, or may induce increases in risk if net exposures are treated as if they were true exposures;

(ii) bilateral netting by novation reduces both liquidity and credit risks to counterparties, and possibly to the financial system (other things being equal), relative to the cases of no netting and bilateral position netting;

(iii) multilateral position netting may reduce liquidity risks relative to the cases of no netting and bilateral netting, under certain circumstances; if significant defaults occur, liquidity risks may be higher; credit risks are the same as, or may be larger than, in the case of no netting; credit risks are greater than in the case of bilateral netting by novation;

(iv) multilateral netting by novation and substitution has the potential to reduce liquidity risks more than any other institutional form, but this depends critically on the financial condition of any central counterparty to the netting; if the liquidity of a central counterparty is weak, the liquidity risks of this institutional form may be greater than in the case of bilateral netting by novation; the credit risks of this institutional form are generally less than in other forms that have been considered, subject again to the identity and condition of any central counterparty.

---

[1] This text is reproduced with permission from the Bank for International Settlements. It is from the *Report on Netting Schemes* 6 (February 1989), prepared by the Group of Experts on Payment Systems of the Central Banks of the Group of Ten Countries.

Appendix II

11 Basle Committee Amendment of the 1988 Capital Accord

Basle Capital Accord: Treatment of Potential Exposure for Off-Balance-Sheet Items*

Text amending the Capital Accord

The following text is to substitute for the section beginning on p. 27 of Annex 3 of the 1988 Capital Accord.** It recognizes the effects of netting in the calculation of the additions, expands the matrix of add-on factors, and also incorporates the language of the July 1994 amendment recognizing bilateral netting in the calculation of current exposure. Footnotes are as they would appear in the amended 1988 Capital Accord.

Forwards, swaps, purchased options and similar derivative contracts

The treatment of forwards, swaps, purchased options and similar derivative contracts needs special attention because banks are not exposed to credit risk for the full face value of their contracts, but only to the potential cost of replacing the cash flow (on contracts showing positive value) if the counterparty defaults. The credit equivalent amounts will depend inter alia on the maturity of the contract and on the volatility of the rates and prices underlying that type of instrument. Instruments traded on exchanges may be excluded where they are subject to daily receipt and payment of cash variation margin. Options purchased over the counter are included with the same conversion factors as other instruments.

Despite the wide range of different instruments in the market, the theoretical basis for assessing the credit risk on all of them has been the same.

---

*This text is reproduced with permission from the Basle Committee on Banking Supervision. It is the Annex to *Basle Capital Accord: Treatment of Potential Exposure for Off-Balance-Sheet Items* (April 1995) by the Basle Committee on Banking Supervision. The *Report on International Convergence of Capital Measurement and Capital Standards* (July 1988), known as the Basle Capital Accord, is reprinted in 1 *Current Legal Issues Affecting Central Banks* 487 (Robert C. Effros ed., 1992), and the 1992 amendment is reprinted in 3 *Current Legal Issues Affecting Central Banks* 296 (Robert C. Effros ed., 1995).

**The corresponding page number in the version reprinted in 1 *Current Legal Issues Affecting Central Banks, supra*, is page 510.

It has consisted of an analysis of the behavior of matched pairs of swaps under different volatility assumptions. Interest rate contracts are defined to include single-currency interest rate swaps, basis swaps, forward rate agreements, interest rate futures, interest rate options purchased and similar instruments. Exchange rate contracts with an original maturity of 14 calendar days or less may be excluded. Gold contracts are treated the same as exchange rate contracts for the purpose of calculating credit risk except that contracts with original maturity of 14 calendar days or less are included. Precious metals other than gold receive a separate treatment and include forwards, swaps, purchased options and similar derivative contracts that are based on precious metals (e.g. silver, platinum, and palladium). Other commodities are also treated separately and include forwards, swaps, purchased options and similar derivative contracts based on energy contracts, agricultural contracts, base metals (e.g. aluminum, copper, and zinc), and any other non-precious metal commodity contracts. Equity contracts include forwards, swaps, purchased options and similar derivative contracts based on individual equities or on equity indices.

The current exposure method

The G-10 supervisory authorities are of the view that the best way to assess the credit risk on these items is to ask banks to calculate the current replacement cost by marking contracts to market, thus capturing the current exposure without any need for estimation, and then adding a factor (the "add-on") to reflect the potential future exposure over the remaining life of the contract. It has been agreed that, in order to calculate the credit equivalent amount of these instruments under this current exposure method, a bank would sum:

- the total replacement cost (obtained by "marking to market") of all its contracts with positive value and
- an amount for potential future credit exposure calculated on the basis of the total notional principal amount of its book, split by residual maturity as follows:

Residual Maturity	Interest Rate	Exchange Rate and Gold	Equity	Precious Metals Except Gold	Other Commodities
One year or less	0.0%	1.0%	6.0%	7.0%	10.0%
Over one year to five years	0.5%	5.0%	8.0%	7.0%	12.0%
Over five years	1.5%	7.5%	10.0%	8.0%	15.0%

Notes:

1. For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract.
2. For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. In the case of interest rate contracts with remaining maturities of more than one year that meet the above criteria, the add-on factor is subject to a floor of 0.5%.
3. Forwards, swaps, purchased options and similar derivative contracts not covered by any of the columns of this matrix are to be treated as "other commodities."
4. No potential future credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

Supervisors will take care to ensure that the add-ons are based on effective rather than apparent notional amounts. In the event that the stated notional amount is leveraged or enhanced by the structure of the transaction, banks must use the effective notional amount when determining potential future exposure.

The original exposure method

At national supervisory discretion,[3] banks may also use a simpler alternative method for interest rate and foreign exchange-related contracts, whereby the potential credit exposure is estimated against each type of contract and a notional capital weight allotted, no matter what the market value of the contract might be at a particular reporting date. The original exposure method may be used until market risk-related capital requirements are implemented, at which time the original exposure method will cease to be available for banks supervised according to this Accord.[4] Banks that engage in forwards, swaps, purchased options or similar derivative contracts based on equities, precious metals except gold, or other commodities are required to apply the current exposure method.

---

[3]Some national authorities may permit individual banks to choose which method to adopt, it being understood that once a bank has chosen to apply the current exposure method, it would not be allowed to switch back to the original exposure method.

[4]Where appropriate, national supervisors may allow an additional transition period, but in no case longer than 12 months.

In order to arrive at the credit equivalent amount using this **original exposure** method, a bank would simply apply one of the following two sets of conversion factors to the notional principal amounts of each instrument according to the nature of the instrument and its maturity:

Maturity[5]	Interest Rate Contracts	Exchange Rate Contracts and Gold
One year or less	0.5%	2.0%
Over one year to two years	1.0%	5.0% (i.e. 2% + 3%)
For each additional year	1.0%	3.0%

Bilateral netting

Careful consideration has been given to the issue of **bilateral netting**, i.e., weighting the net rather than the gross claims with the same counterparties arising out of the full range of forwards, swaps, options and similar derivative contracts.[6] The Committee is concerned that if a liquidator of a failed counterparty has (or may have) the right to unbundle netted contracts, demanding performance on those contracts favorable to the failed counterparty and defaulting on unfavorable contracts, there is no reduction in counterparty risk.

Accordingly, it has been agreed for capital adequacy purposes that:

(a) Banks may net transactions subject to novation under which any obligation between a bank and its counterparty to deliver a given currency on a given value date is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single amount for the previous gross obligations.

(b) Banks may also net transactions subject to any legally valid form of bilateral netting not covered in (a), including other forms of novation.

(c) In both cases (a) and (b), a bank will need to satisfy its national supervisor that it has:[7]

[5] For interest rate contracts, there is national discretion as to whether the conversion factors are to be based on original or residual maturity. For exchange rate contracts and gold, the conversion factors are to be calculated according to the original maturity of the instrument.

[6] Payments netting, which is designed to reduce the operational costs of daily settlements, will not be recognized in the capital framework since the counterparty's gross obligations are not in any way affected.

[7] In cases where an agreement as described in (a) has been recognized prior to July 1994, the supervisor will determine whether any additional steps are necessary to satisfy itself that the agreement meets the requirements set out below.

(1) a netting contract or agreement with the counterparty which creates a single legal obligation, covering all included transactions, such that the bank would have either a claim to receive or obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions in the event a counterparty fails to perform due to any of the following: default, bankruptcy, liquidation or similar circumstances;

(2) written and reasoned legal opinions that, in the event of a legal challenge, the relevant courts and administrative authorities would find the bank's exposure to be such a net amount under:

- the law of the jurisdiction in which the counterparty is chartered and, if the foreign branch of a counterparty is involved, then also under the law of the jurisdiction in which the branch is located;
- the law that governs the individual transactions; and
- the law that governs any contract or agreement necessary to effect the netting.

The national supervisor, after consultation when necessary with other relevant supervisors, must be satisfied that the netting is enforceable under the laws of each of the relevant jurisdictions;[8]

(3) procedures in place to ensure that the legal characteristics of netting arrangements are kept under review in the light of possible changes in relevant law.

Contracts containing walkaway clauses will not be eligible for netting for the purpose of calculating capital requirements pursuant to this Accord. A walkaway clause is a provision which permits a non-defaulting counterparty to make only limited payments, or no payment at all, to the estate of a defaulter, even if the defaulter is a net creditor.

For banks using the **current exposure** method, credit exposure on bilaterally netted forward transactions will be calculated as the sum of the net mark-to-market replacement cost, if positive, plus an add-on based on the notional underlying principal. The add-on for netted transactions (A_{Net}) will equal the weighted average of the gross add-on (A_{Gross})[9] and the gross add-on adjusted by the ratio of net current replacement cost to

[8]Thus, if any of these supervisors is dissatisfied about enforceability under its laws, the netting contract or agreement will not meet this condition and neither counterparty could obtain supervisory benefit.

[9]A_{Gross} equals the sum of individual add-on amounts (calculated by multiplying the notional principal amount by the appropriate add-on factors set out in this Annex) of all transactions subject to legally enforceable netting agreements with one counterparty.

gross current replacement cost (NGR). This is expressed through the following formula:

$$A_{Net}=0.4*A_{Gross}+0.6*NGR*A_{Gross}$$

where

NGR=level of net replacement cost/level of gross replacement cost for transactions subject to legally enforceable netting agreements.[10]

The scale of the gross add-ons to apply in this formula will be the same as those for non-netted transactions as set out in this Annex. The Committee will continue to review the scale of add-ons to make sure they are appropriate. For purposes of calculating potential future credit exposure to a netting counterparty for forward foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, notional principal is defined as the net receipts falling due on each value date in each currency. The reason for this is that offsetting contracts in the same currency maturing on the same date will have lower potential future exposure as well as lower current exposure.

The **original exposure** method may also be used for transactions subject to netting agreements which meet the above legal requirements until market risk-related capital requirements are implemented. The conversion factors to be used during the transitional period when calculating the credit exposure of bilaterally netted transactions will be as follows:

Maturity	Interest Rate Contracts	Exchange Rate Contracts
One year or less	0.35%	1.5%
Over one year to two years	0.75%	3.75% (i.e. 1.5% + 2.25%)
For each additional year	0.75%	2.25%

[10]National authorities may permit a choice of calculating the NGR on a counterparty by counterparty or on an aggregate basis for all transactions subject to legally enforceable netting agreements. If supervisors permit a choice of methods, the method chosen by an institution is to be used consistently. Under the aggregate approach, net negative current exposures to individual counterparties cannot be used to offset net positive current exposures to others, i.e., for each counterparty the net current exposure used in calculating the NGR is the maximum of the net replacement cost or zero. Note that under the aggregate approach, the NGR is to be applied individually to each legally enforceable netting agreement so that the credit equivalent amount will be assigned to the appropriate counterparty risk weight category.

These factors represent a reduction of approximately 25% from those on page 29 of the Accord.*** For purposes of calculating the credit exposure to a netting counterparty during the transitional period for forward foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, the credit conversion factors on page 29 of the Accord**** could be applied to the notional principal, which would be defined as the net receipts falling due on each value date in each currency. In no case could the reduced factors above be applied to net notional amounts.

Risk weighting

Once the bank has calculated the credit equivalent amounts, whether according to the current or the original exposure method, they are to be **weighted** according to the category of counterparty in the same way as in the main framework, including concessionary weighting in respect of exposures backed by eligible guarantees and collateral. In addition, since most counterparties in these markets, particularly for long-term contracts, tend to be first-class names, it has been agreed that a 50 per cent weight will be applied in respect of counterparties which would otherwise attract a 100 per cent weight.[11] However, the Committee will keep a close eye on the credit quality of participants in these markets and reserves the right to raise the weights if average credit quality deteriorates or if loss experience increases.

***The corresponding page number in the version reprinted in 1 *Current Legal Issues Affecting Central Banks, supra*, is page 512.

****The corresponding page number in the version reprinted in 1 *Current Legal Issues Affecting Central Banks, supra*, is page 512.

[11]Some member countries reserve the right to apply the full 100% weight.

Appendix II

12 Basle Committee Report on Asset Transfers and Securitisation

ASSET TRANSFERS AND SECURITISATION[1]

This report reviews some aspects of asset transfers and securitisation by focusing largely on the transferor or issuer of asset-backed securities rather than on the purchaser or investor. It describes the mechanics of the securitisation process, the incentives for securitisation and the risks associated with it, and considers some of the factors that influence supervisors' response.

1. Introduction

In recent years banks have been increasingly active in the process of transferring loans or other assets, whether in part or in whole and, more recently, in issuing securities backed by these assets. Transfers of loans or participation in loans are now more common in most G-10 countries. Securitisation is more complex, is therefore less common, and in some countries is not permitted by existing legal arrangements.

Asset securitisation has become most popular in the United States, particularly with regard to mortgage loans where about 40% of the outstanding residential mortgage debt has been securitised. This process has undoubtedly been encouraged by the support of federal government agencies which provide credit enhancement to investors. However, the process is now being used for other types of loans, such as credit card receivables and other consumer loans, and substantial increases in market volume have been recorded. Outside the United States significant amounts of mortgage-backed securities have been issued in Canada and the United Kingdom and interest is growing by banks and financial insti-

[1]This text is reproduced with permission from the Basle Committee on Banking Supervision. It consists of Chapter IX of the ***Report on International Developments in Banking Supervision*** (Report number 8, September 1992), prepared and distributed by the Basle Committee on Banking Supervision.

(The chapter reproduces the text of an analysis by a working group of the Basle Committee. Although it has not been formally approved, the Committee felt it would be useful to make the report available to other supervisors for information.)

tutions in other countries who wish to participate in the securitisation business (see annex).[2]

Asset securitisation in its basic form consists of the pooling of a group of homogeneous loans, the sale of these assets to a special purpose company or trust, and the issue by that entity of marketable securities against the pooled assets. The payment of interest and principal on the securities is directly dependent on the cash-flows arising from the underlying pooled assets. Asset-backed securities are attractive to investors as their returns tend to be high relative to the credit risk; credit enhancement is normally provided for a portion or the whole amount of the issue. Moreover, denominations and cash-flows can be structured to meet the cash flow and other needs of particular types of investor.

However, asset securitisation schemes are not static. Many securitisation techniques have been invented relatively recently and the pace of innovation appears to be accelerating. Some of the new models involve not only complex and sophisticated structures but also seek to enlarge the type and composition of loans suitable for pooling and securitisation. Although credit losses have been negligible so far, some of the newer techniques have not yet been fully tested in times of stress or disruption in the securities markets.

For banks the process provides a number of benefits in respect of prudential requirements, asset and liability management, and profitability, and these provide the incentive to participate in the securitisation process. In addition non-bank financial institutions increasingly participate, as the process separates the exercise of functions normally carried out by a lending bank, thus enabling these institutions to enter the business of financial intermediation more easily.

A number of concerns have been raised in connection with asset securitisation. The main ones are that credit risk could remain with the bank if a clean sale does not take place and the securitisation could damage the asset quality of a bank if it is a bank's best assets that are securitised. Moreover, certain structures can lead to credit flowing directly from end-investors to end-borrowers changing and perhaps lessening the role of banks in the intermediary process.

The impact of asset securitisation on the overall risk profile of a bank therefore demands close attention by bank supervisors in order to ensure that banks conduct this business in a prudent manner. There are also implications for banks in the similar activities of non-bank participants who can take the same risk but who may not be as adequately supervised.

---

[2] This annex is not reprinted herein.

2. Mechanics of the Asset Securitisation Process

(a) Packaging, Sale and Administration

To initiate the securitisation process a pool of homogeneous assets such as mortgages, credit card receivables or automobile loans is created. Homogeneity is necessary to enable a cost-efficient analysis of the credit risk of the pooled assets and to achieve a common payment pattern. The originator of a securitisation scheme can be a bank or another financial institution. If a bank is the originator it may take the assets from its own loan portfolio, but the securitisation of assets that are purchased from a third party or that are non-bank assets (e.g. receivables of commercial companies) is becoming more prevalent.

In the second step the pool is sold to a special purpose vehicle (SPV) which finances the purchase by issuing securities backed by the pool of assets and which are the sole assets of the SPV. At that stage further parties, together with a rating agency, are often involved to give advice to the originator, analyze the credit quality of the portfolio, and structure the transaction. If an underwriter participates in the scheme the securities may pass through his books before being sold to investors.

To facilitate the securitisation process a servicer and a trustee are normally involved. The servicer—who in many instances is the originator—is responsible for the collection of interest and principal repayments deriving for the pooled assets and the remittance of these funds to the trustee. The servicer is entitled to receive a fee for these services and in addition may benefit from the temporary investment of the funds collected pending periodic onward transmission. Its servicing capacity and expertise will be reviewed by the rating agencies. The rating of the originator/servicer, along with the rating agency assessment of the quality of the underlying assets and the structure of the scheme, will affect the extent of the credit enhancement that may need to be provided or arranged, especially if the rating of the assets is lower than that desired by potential investors.

The trustee acts on behalf of the investors. In that capacity he must have a priority interest in the assets supporting the security issue, an ability to oversee the performance of the other parties involved in the transaction including the servicer, review periodic information on the status of the pool, superintend the distribution of the cash flows to the investors and, if necessary, declare the issue in default and take the legal actions that are necessary to protect the investors' interests.

(b) Credit and Liquidity Enhancement

As investors are not normally prepared to take on all the credit risks associated with a pool of loans, asset-backed securities are usually provided with credit enhancement by a third party bank or insurance company and sometimes by the originator. Often different forms of enhancement may be combined. The simplest form of enhancement would be a recourse arrangement providing the buyer of the assets with the right to receive payment from the enhancer if the obligator fails to pay when due. However, such an arrangement would be regarded as shifting the credit risk fully to the provider of the recourse and is not therefore often used.

To determine the appropriate enhancement the estimated credit risk in the pooled assets is assessed together with its historic loss profile. Usually this results in an enhancement that covers, by a multiple of several times, the historic default rates of the underlying assets. The most common forms of such credit enhancements are: irrevocable letters of credit, third-party insurance, spread accounts, cash collateral accounts, over-collateralisation and senior-subordinated structures.

An irrevocable *letter of credit* may be issued by a third party bank to cover a portion of the assets normally equal to the estimated loss profile and is often subordinated to the other enhancements.

Non-bank insurance companies have also been active in the United Kingdom by providing a *third party insurance* against the first portion of the default risk.

A *spread account* is a deposit typically built up from the spread between the interest paid on the pooled assets and the lower interest paid on the securities issued. The servicer, instead of passing the spread back to the originator, passes on all funds collected to the trustee where the spread is accumulated up to the level required for the credit enhancement. After having reached this level all future spread earning can be passed back to the originator. To provide for early losses the originator normally has to deposit funds in the spread account in advance. The account is used to cover any losses occurring on the pooled assets, and any balance left over in the spread account when the securities are redeemed reverts to the originator.

A *cash collateral account* is a deposit equal to the necessary credit enhancement which is held for the benefit of the holders of the securities. The account will be drawn down if and when losses occur. Cash advances are made to this cash account by the originator or a third party lender.

Over-collateralisation means that the value of the underlying assets in the pool exceeds the amount of the securities issued. In such schemes the

excess collateral must be maintained at a level sufficient to provide the agreed amount of credit enhancement. If the value declines below that level the enhancer must fill the gap with new collateral.

Where credit enhancement is provided by a ***senior-subordinated structure*** at least two classes of securities are issued. The senior tranche has a prior claim on the cash flows from the underlying assets so that all losses will accrue first to the junior securities up to the amount of this particular class. If for example an issue consists of 90% senior and 10% junior securities the holders of the junior securities will carry all of the losses up to 10% of the total assets in the scheme.

At first glance all these forms of credit enhancement appear to support only a portion of the total portfolio but in reality they consist of highly condensed credit risk. Normally, the credit enhancements, which as noted above are often used in combination with one another, will effectively cover several multiples of expected losses in the total portfolio and the provider is therefore in the same position as if he had owned all the assets. Where there are several enhancements the losses will be shared among them in a predetermined order. These factors need to be taken into account when applying capital requirements to the credit enhancers themselves (see section 5(c)).

Another enhancement technique that may be used for the issue of asset-backed securities is ***liquidity support***. It is particularly common for asset-backed commercial paper programmes. These issues include in the pool of underlying assets different types of receivables. However, the maturity of the receivables usually does not match that of the commercial paper, which therefore has to be rolled over or replaced by new issues.

To cover the risk that the issuer cannot renew the paper as it falls due the liquidity enhancer agrees to provide the funds required. Although formally the liquidity enhancer is not guaranteeing the securities but is providing a short-term loan facility to the issuer, he effectively takes on the residual risk beyond that taken by the credit enhancement of the underlying receivables, which are the sole assets of the issuing special purpose vehicle. Therefore, whether the liquidity support can be regarded solely as a pure liquidity line depends on any enhancement being subordinated to the liquidity line in the event of liquidation.

3. Incentives for Asset Securitisation

The main benefit from asset securitisation is that it enables banks to pass the risks of lending on to other parties, thus freeing capital resources to back new lending which would otherwise be beyond their capacity. The funding and liquidity benefits of the securitisation process derive

from the conversion of illiquid assets into liquid funds available for additional lending. Because of the credit enhancements, the rating of asset-backed securities is often higher than that of the originator who is therefore able to tap funding sources not normally accessible to him.

Asset securitisation also helps banks in their asset and liability management. Interest rate risk can be reduced by passing it on to the investors. A bank wishing to extend its lending but not having funds of adequate maturity can avoid a security mismatch by securitising the new loans. Securitisation offers a bank which is heavily exposed to a particular region or economic sector an ability to transfer part of its loan portfolio and also to purchase with the proceeds other types of ABS thus achieving a more diversified loan portfolio.

Banks engaging in one or more of the securitisation roles, such as lender, servicer, trustee, or enhancer, can increase and diversify their sources of fee and interest income. By transferring assets banks can continue their existing types of lending or invest the proceeds in other lines of business and avoid concentration in a single type of credit risk.

Asset securitisation can also have important benefits for borrowers. Since such securitisation generally helps to improve the liquidity of credit markets, it can increase the availability of credit to borrowers and can allow borrowers to obtain funds at a lower cost.

4. Implications of Asset Securitisation

(a) Risks for Banking Organisations

The securitisation process, if not carried out prudentially, can leave risks with the originating bank without allocating capital to back them. While all banking activity entails operational and legal risks, these may be greater the more complex the activity. But the main risk a bank may face in a securitisation scheme arises if a true sale has not been achieved and the selling bank is forced to recognise some or all of the losses if the assets subsequently cease to perform. Funding risks and constraints on liquidity may also arise if assets designed to be securitised have been originated, but because of disturbances in the market the securities cannot be placed. There is also at least a potential conflict of interest if a bank originates, sells, services, and underwrites the same issue of securities.

A bank that has originated and transferred assets effectively may nonetheless be exposed to moral pressure to repurchase the securities if the assets cease to perform. The complexity of securitisation schemes could contribute to such pressure. After having completed the securitisation transaction the seller does not in general disappear but exercises

other functions in the process. These functions and the fact that the investors are well aware of the identity of the provider of the assets backing the securities may give rise to links between seller and investor that could, at least morally, cause the seller to be under pressure to protect its reputation and to support the securitisation scheme.

The risks for banks acting as a servicer are principally operational and are comparable to those of an agent bank for a syndicated loan. However, the number of loans in the portfolio and the different parties involved in a securitisation scheme means that there are higher risks of malfunction for which the servicer might also become liable. Thus, servicers need to engage sophisticated personnel, equipment and technology to process these transactions in order to minimise operational risk.

It is sometimes contended that banks in seeking a good market reception for their securitised assets may tend to sell their best quality assets and thereby increase the average risk in their remaining portfolio. Investor and rating agency demand for high quality assets could encourage the sale of an institution's better quality assets. Moreover, an ongoing securitisation program needs a growing loan portfolio and this could force a bank to lower its credit standards to generate the necessary volume of loans. In the end a capital requirement that assumes a well diversified loan portfolio of a given quality might prove to be too low if the average asset quality has deteriorated. Such arguments are not easy to support with empirical evidence. Banks that have securitised large amounts of assets do not exhibit signs of lower asset quality. It should also be noted that banks which constantly securitise assets are necessarily interested in maintaining the quality of their loan portfolio. Any asset quality deterioration would affect their reputation and their rating and indeed the capital adequacy requirement imposed by their supervisors.

The securitisation of revolving credits such as credit-card receivables is a particularly complicated example which involves the issue of securities of a fixed amount and term against assets of a fluctuating amount and indefinite maturity. A portfolio of credit-card receivables fluctuates daily as the individual accounts increase and decrease, and because of the different repayment patterns by credit-card users (e.g. by fast and slow payers). It is also likely that as a scheme matures the security holders will be repaid out of a fixed share of gross flow on the accounts in the pool, so deriving repayment principally from fast payers who resolve their debt quickly. Such schemes need a structure adequate to ensure control of the amortisation process and to ensure appropriate risk-sharing during amortisation by the security-holders.

(b) Implications for Financial Systems

The possible effects of securitisation on financial systems may well differ between countries because of differences in the structure of financial systems or because of differences in the way in which monetary policy is executed. In addition, the effects will vary depending upon the stage of development of securitisation in a particular country. The net effect may be potentially beneficial or harmful, but a number of concerns are highlighted below that may in certain circumstances more than offset the benefits. Several of these concerns are not principally supervisory in nature, but they are referred to here because they may influence monetary authorities' policy on the development of securitisation markets.

While asset transfers and securitisations can improve the efficiency of the financial system and increase credit availability by offering borrowers direct access to end-investors, the process may on the other hand lead to some diminution of the importance of banks in the financial intermediation process. In the sense that securitisation could reduce the proportion of financial assets and liabilities held by banks, this could render more difficult the execution of monetary policy in countries where central banks operate through variable minimum reserve requirements. A decline in the importance of banks could also weaken the relationship between lenders and borrowers, particularly in countries where banks are predominant in the economy.

One of the benefits of securitisation, namely the transformation of illiquid loans into liquid securities, may lead to an increase in the volatility of asset values, although credit enhancements could lessen this effect. Moreover, the volatility could be enhanced by events extraneous to variations in the credit standing of the borrower. A preponderance of assets with readily ascertainable market values could even, in certain circumstances, promote liquidation as opposed to going-concern concept for valuing banks.

Moreover, the securitisation process might lead to some pressure on the profitability of banks if non-bank financial institutions exempt from capital requirements were to gain a competitive advantage in investment in securitised assets.

Although securitisation can have the advantage of enabling lending to take place beyond the constraints of the capital base of the banking system, the process could lead to a decline in the total capital employed in the banking system, thereby increasing the financial fragility of the financial system as a whole, both nationally and internationally. With a substantial capital base, credit losses can be absorbed by the banking system. But the smaller that capital base is, the more the losses must be shared by

others. This concern applies, not necessarily in all countries, but especially in those countries where banks have traditionally been the dominant financial intermediaries.

5. Supervisory Conditions

Supervisors of individual institutions need to assess carefully whether the risk associated with a particular securitisation scheme has been effectively transferred to the investor or the credit enhancer, in full or in part, and satisfy themselves that the scheme is managed in a prudent manner so that the operational risks are kept to an acceptable level.

(a) The Concept of a True Sale

As a first step, supervisors need to assess whether or not a true sale of the assets, covering both the legal and, to the extent practical, the moral aspects, has been achieved. Where a true sale has not been achieved, capital support clearly continues to be required.

A bank selling its assets to an originator of a securitisation scheme or originating a scheme by pooling its own assets or assets purchased from a third party could be presumed not to have executed a true sale if there is, inter alia, any obligation:

- to repurchase or exchange any of the assets;
- for any kinds of legal recourse through which any risk of loss from the assets sold could be retained or put back to the selling bank;
- to any party for the payment of principal or interest on the assets sold (other than those arising as services).

In any of these three cases the assets normally should remain as a claim on the capital of the bank.

There would also be doubts whether a true sale of own or third party assets has been accomplished if the selling bank has ownership or exercises any equity or management control for the benefit of the bank over the special purpose vehicle that owns the pooled assets and issues the securities, or is required to consolidate the SPV as a subsidiary in its financial statements. A further indication that there may be strong links between the selling bank and the scheme is the inclusion of the name of the selling bank in the name of the vehicle.

Furthermore, any credit enhancement (and possibly some liquidity enhancements) provided by the selling bank may be indicators that the bank has accepted a liability on recourse and therefore no true sale has

been achieved. This would also include the retention of any subordinated class of securitised assets.

There might be some exceptions. In some countries a spread account could be regarded as not being provided by the originator but by the scheme itself. Alternatively, initial payment into such an account by the originating bank could be reasonable, if the initial payment was deducted from capital. Liquidity support provided by the seller together with a significant credit enhancement by a third party, subordinated to the seller, could be regarded as a credit line. In these cases the enhancements could be regarded as not obstructing a true sale. No capital support for credit risk would therefore be needed, but capital support would continue to be required in those cases where risk remains with the bank.

(b) Administration of Securitisation Schemes

A bank which is involved in the administration of a securitisation scheme merely as a servicer or trustee may nonetheless be exposed to some form of moral obligation to offer recourse. The element of moral hazard may be greater if the servicer is also the originator. Therefore, in order to avoid a capital charge as a result of its administrative responsibilities, the bank generally needs to ensure that any offering circular contains a highly visible, unequivocal statement that it does not stand behind the issue or the vehicle and will not make good on any losses in the portfolio. For servicing the scheme the bank may of course receive a benefit from the transaction but this ought clearly to be seen as a fee for services provided and not as a reward for incurring risk of ownership.

A bank may be closely connected to the pool and become exposed to credit risks by virtue of its administrative duties. Indications of the existence of such a commitment are, as already mentioned, a requirement to consolidate the special purpose vehicle or the inclusion of its name in the name of the vehicle.

Other indications of possible credit support are:

- an obligation to provide support to the vehicle or the scheme, for example, by covering losses of the issue;
- an obligation to remit funds to the buyer before they are received from the obligor, or to cover cash shortfalls arising from delayed payments or non-performance of assets being administered unless these are solely tools to facilitate the timing of cash flows.

In all these cases there must be a strong presumption that the bank is exposed to credit risk in some form and such risk deserves to be supported by the holding of appropriate capital.

(c) Credit Enhancement or Liquidity Support by a Third Party Bank

Credit enhancement for a securitisation scheme provided by a third party bank is comparable to an off-balance-sheet exposure and is generally treated as a direct credit substitute. One supervisory response might be for the whole amount of the pooled assets to be taken into account and risk weighted, particularly if the bank's enhancement is supporting the first losses that arise or if the amount of loss covered is significant by reference to historical loss experience. An alternative approach would be for the enhancement to be deducted from the providing bank's capital.

Liquidity support given in cases where there is no significant third party credit enhancement, and the liquidity support is in fact providing credit enhancement to the scheme, ought to be regarded as effectively a guarantee of the securities and be treated in a way similar to a credit enhancement given by a third party bank. Pure liquidity support given in cases where there are separate arrangements for significant credit enhancement can generally be treated solely as a liquidity facility and as a commitment for capital adequacy purposes.

Appendix II

13 The London Code of Conduct for Principals and Broking Firms in the Wholesale Markets

I. INTRODUCTION[1]

Aims

1. The London financial markets have a long-established reputation for their high degree of professionalism and the maintenance of the highest standards of business conduct. All those operating in these markets share a common interest in their health and in maintaining the established exacting standards.

2. The Code is applicable to most wholesale market dealings which are not regulated by the rules of a recognized investment exchange. These typically form part of 'treasury' operations and are undertaken in large amounts. A full list of the products covered and the appropriate size criteria are shown in the box opposite.[2]

3. The Bank of England (the Bank) wishes to sustain the efficient functioning of the London wholesale markets in which these products are traded and to avoid over-burdensome regulation; and believes that this Code is consistent with these objectives.

4. The Code has been developed in close consultation with market practitioners and will continue to be kept under regular review. A fuller description of the Bank's regulatory arrangements covering the wholesale markets, of which this Code is an integral part, is set out in the 'Grey Paper' (The regulation of the wholesale markets in sterling, foreign exchange and bullion) available from the Wholesale Markets Supervision Division of the Bank of England.

5. The Code sets out the general standards and controls which the management and individuals at broking firms (including electronic broking firms) are **'core principals'** (banks, building societies plus financial institutions authorised under the Financial Services Act 1986) should adopt when transacting business in the relevant financial products. Furthermore, the Chartered Institute of Public Finance and Accountancy and the Association of Corporate Treasurers commend the Code to their

[1]This text is reproduced with the permission of the Bank of England. The foreword, table of contents, and annexes to this text are omitted. This July 1995 text supersedes that issued in May 1992.

[2]Pages 818–19 of this text.

PRODUCTS COVERED BY THE BANK'S WHOLESALE MARKETS ARRANGEMENTS

A: Cash Market Products

1. Sterling wholesale deposits.
2. Foreign currency wholesale deposits.
3. Gold and silver bullion wholesale deposits.
4. Spot and forward foreign exchange.
5. Spot and forward gold and silver bullion.

B: Instruments which are defined as investments in the Financial Services Act but which are outside the scope of the Investment Services Directive:

6. Over the counter (OTC) options (including warrants) or futures contracts on gold or silver.

C: Instruments which are defined as investments in the Financial Services Act and are within the scope of the Investment Services Directive:

7. Certificates of deposit (CDs), or other debt instruments, issued by institutions authorised under the Banking Act 1987, European authorised institutions, and by UK building societies, with an original maturity of not more than 5 years. (This class of instrument is included in the Financial Services Act under the generic term 'debenture').
8. Bank Bills (or bankers' acceptances).*
9. Other debentures with an original maturity of not more than 1 year (including non-London CDs and commercial paper).
10. Medium-term notes issued under the Banking Act 1987 (Exempt Transactions) (Amendment) Regulations.
11. UK local authority debt (bills, bonds, loan stock or other instruments) with an original maturity of not more than 5 years.
12. Other public sector debt with an original maturity of not more than 1 year (e.g. Treasury bills but **not** gilt-edged securities).
13. Any certificate (or other instrument) representing the securities covered in items 7–12; or rights to and interests in, these instruments.
14. OTC options (including warrants) or futures contracts on any currency (including sterling); interest rate; or items 7–13 above.

members, which also deal as principal in these markets, as best practice, to which they, too, should adhere.

Distribution

6. It is the responsibility of broking firms/core principals to seek to establish whether their UK based clients/counterparties have a copy of

15. Interest rate and currency swaps, regardless of their original maturity; forward rate agreements, or any other 'contracts for differences' involving arrangements to profit (or avoid loss) by reference to movements in the value of any of the instruments in 7–13 above; or the value of any currency; or in the interest on loans in any currency.
16. Sale and repurchase agreements ('repos'), sale and buybacks and stock borrowing and lending involving debentures, loan stock or other debt instruments, including gilts, of whatever original maturity where the repurchase or repayment will take place within twelve months.

Note 1. Instruments subject to the rules of a recognised investment exchange are **not** covered.

Note 2. Instruments denominated in foreign currencies, as well as in sterling **are** covered.

Note 3. Transactions by listed institutions may come within the Bank's supervisory framework even if one of the other parties to the transaction is operating abroad.

Note 4. The regulation of the deposit-taking under the Banking Act 1987 is not affected in any way.

Note 5. The Government made clear in January 1988 that ordinary forward foreign exchange (and bullion) transactions fall outside the Financial Services Act; these nevertheless fall within the scope of the Bank's arrangements.

Note 6. Wholesale transactions between core principals in items 1 and 8 are not usually less than £100,000. For items 2 and 4, the usual minimum is £500,000 (or currency equivalent). For bullion (items 3 and 5), the relevant amounts are 2,000 ounces for gold and 50,000 ounces for silver.

Note 7. For items 7, 9–13, and 16, the minimum size of wholesale transactions is £100,000 (or the equivalent in foreign currency). For swaps, options, futures, forward rate agreements (FRAs) and other 'contracts for differences' (items 6, 14 and 15) the minimum underlying value is £500,000 (or the equivalent in foreign currency).

*With effect from 1 January 1996, following amendment to the Financial Services Act.

the Code. If they do not, they should send them one or advise them to contact the Bank direct. Where relevant, local authorities plus other institutions and companies in the UK are encouraged to adopt a similar approach.

7. The Bank will seek to make as many as possible **overseas based** firms aware that their wholesale market deals in the London market are undertaken in accordance with the London Code. If broking firms or

core principals receive any questions from overseas based firms about their wholesale market deals they should, where appropriate, make them aware of the Code's existence; and that copies can be obtained from the Bank. Non-core principals are encouraged to adopt a similar approach.

Compliance and Complaints

8. **Compliance with the Code is necessary to ensure that the highest standards of integrity and fair dealing continue to be observed throughout these markets.** Breaches by those institutions which they supervise will be viewed most seriously by the Bank and by the Building Societies Commission; any such breaches may be reflected in their assessment of the fitness and propriety of these institutions. In addition, the Securities and Investments Board and the UK Self-Regulating Organisations expect those core principals which they supervise to abide by the code when dealing in the wholesale markets.

9. If any principal (core or non-core) or broking firm believes that an institution supervised by the Bank has breached either the letter or the spirit of the Code in respect of any wholesale market transaction in which it is involved, it is encouraged—whether or not it is itself supervised by the Bank—to seek to settle this matter amicably with the other party. If this is not possible, the institution which is subject to the complaint should make the complainant aware that it can bring the matter to the attention of the Head of Wholesale Markets Supervision Division of the Bank of England. All such complaints will be investigated by the Bank. As a general rule the Bank will seek evidence from all parties named in the complaint and will wish to discuss this in detail with management of the institution subject to the complaint.

10. Where a breach of the Code by a bank or other firm listed by the Bank under Section 43 of the Financial Services Act (FSA)—a 'listed institution'—is established, and depending on how serious it is, the Bank may publicly reprimand individuals and/or the firms involved. It may also restrict a listed institution's activities or, if the breach is sufficiently serious to cast doubt on the competence of the firm or on its integrity, suspend or remove the offending firm from the list. The Bank will seek to promulgate its decision as widely as it considers appropriate; in so doing the Bank will wish to consider the possible implications of making its findings known to others.

11. Since the compensation fund arrangements established under the FSA do not apply to any exempt business undertaken by listed institutions, if any breaches of the Code are found to have occurred, the offending institution will be expected to consider making appropriate redress to

any damaged party or parties, bearing in mind any legal implications of so doing.

Arbitration

12. In order to help resolve differences the Bank is willing, if asked, to arbitrate in disputes between firms it supervises. These arrangements are set out in more detail in paragraph 120.

II. GENERAL STANDARDS

Core principals and broking firms—and their employees—should at all times abide by the spirit as well as the letter of the Code when undertaking, arranging or advising on transactions in the wholesale markets.

Managers of core principals and broking firms must ensure that the obligations imposed on them and their staff by the general law are observed. Management and staff should also be mindful of any relevant rules and codes of practice of other regulatory bodies.

Responsibilities

- **Of the principal/broker**

13. All firms (core principals and brokers) should ensure that they and, to the best of their ability, all other parties act in a manner consistent with the Code so as to maintain the highest reputation for the wholesale markets in London.

14. Core principals which conduct non-investment business (see the box on page 3)[1] with private individuals should have internal procedures which set out whether these individuals will be treated as retail customers or as wholesale market participants under the arrangements set out in this Code. The procedures set out in Part IV of this Code may not be relevant, directly, to such business.

15. It is essential that all relevant staff are made familiar with the Code and conduct themselves at all times in a thoroughly professional manner. In particular they must conduct transactions in a way that is consistent with the procedures set out in Part IV of this Code.

16. All firms will be held responsible for the actions of their staff. They must:

— ensure that any individual who commits the firm to a transaction has the necessary authority to do so.

[1] Pages 818–19 of this text.

— ensure that employees are adequately trained in the practices of the markets in which they deal/broke; and are aware of their own, and their firm's, responsibilities. Inexperienced dealers should not rely on a broker, for instance, to fill gaps in their training or experience; to do so is clearly **not** the broker's responsibility.
— ensure staff are made aware of and comply with any other relevant guidance that may from time to time be issued by the Bank.
— ensure that employees comply with any other regulatory requirements that may be applicable or relevant to a firm's activities in the wholesale markets.

17. When establishing a relationship with a **new** counterparty or client, firms must take steps to make them aware of the precise nature of firms' liability for business to be conducted, including any limitations on that liability and the capacity in which they act. **In particular, broking firms should explain to a new client the limited role of brokers (see paragraphs 29 and 30 below).**

18. All firms should identify any potential or actual **conflicts of interest** that might arise when undertaking wholesale market transactions and take measures either to eliminate these conflicts or control them such as to ensure the fair treatment of counterparties.

19. All firms should **know their counterparty**. For principals this is essential where the nature of the business undertaken requires the assessment of creditworthiness. Before dealing with another principal for the first time in any product covered by this Code, core principals should ensure that appropriate steps (see Part III of this Code) are taken.

20. As part of the 'know your counterparty' process firms must take all necessary steps to prevent their transactions in the wholesale markets being used to facilitate **money laundering**. To this end firms should be familiar with the Guidance Notes published in 1995.[1] These make clear the very limited responsibilities name passing brokers have in this area; in particular banks (and others that use brokers) should **not** seek to rely on brokers to undertake anything other than identity and location checks on their behalf.

21. As a general rule core principals will assume that their counterparties have the capability to make independent decisions and to act accordingly; it is for each counterparty to decide if it needs to seek independent advice. If a non-core principal wishes to retain a core principal as its finan-

[1] Available from the British Bankers' Association, 10 Lombard Street, London EC3V 9EL.

cial adviser it is strongly encouraged to do so in writing, setting forth the exact nature and extent of the reliance it will place upon the core principal. All principals should accept responsibility for entering into wholesale market transactions and any subsequent losses they might incur. They should assess for themselves the merits and risks of dealing in these markets. Non-core principals must recognize that it is possible for core principals to take proprietary positions which might be similar or opposite to their own.

22. It is good practice for **principals**, subject to their own legal advice, to alert counterparties to any legal or tax uncertainties which they know are relevant to a proposed relationship or transaction, in order that the counterparty may seek its own advice if it so wishes.

23. Management of **broking** firms should advise their employees of the need to ensure that their behavior could not **at any time** be construed as having misled counterparties about the limited role of brokers (see paragraphs 29 and 30 below); failure to be vigilant in this area will adversely affect the reputation of the broking firm itself.

- **Of the employee**

24. When entering into or arranging individual deals, dealers and brokers must ensure that at all times great care is taken not to misrepresent in any way the nature of any transaction. Dealers and brokers must ensure that:

- the identity of the firm for which they are acting and its role is clear to their counterparties/clients to avoid any risk of confusion. This is particularly important, for instance, where an individual dealer acts for more than one company, or in more than one capacity. If so, he must make absolutely clear, at the outset of any deal, on behalf of which company or in which capacity he is acting.
- it is clearly understood in which products they are proposing to deal.
- any claims or acknowledgements about, or relevant to, a particular transaction being considered should, as far as the individual dealer or broker is aware, be fair and not misleading.
- facts believed to be material to completing a specific transaction are disclosed before the deal is done, except where such disclosure would reveal confidential information about the activities of another firm. Unless specifically asked for more information, or clarification, a dealer at a core principal will assume his counterparty has all the necessary information for this decision making process when entering into a wholesale market transaction.

25. When a deal is being arranged through a broker, the broker should act in a way which does not unfairly favour one client, amongst those involved, over another, irrespective of what brokerage arrangements exist between them and the broking firm.

Clarity of role

- **Role of principals**

26. The role of firms acting as principal is to deal for their own account. **All principals have the responsibility for assessing the creditworthiness of their counterparties or potential counterparties whether dealing direct or through a broking firm. It is for each principal to decide whether or not to seek independent professional advice to assist in this process.**

27. **It is also for the principal to decide what credence, if any, is given to any information or comment provided by a broker to a dealer. Where such information or comment might be interpreted as being relevant to a particular counterparty or potential counterparty, this does not alter the fact that the responsibility for assessing the creditworthiness of a counterparty, whether or not it is supervised, rests with the principal alone.**

28. Some firms may act as agent for connected or other companies as well as, or instead of, dealing for their own account. If so, such agents should:

— always make absolutely clear to all concerned the capacity in which they are acting (e.g. if they also act as principal or broker).
— declare at an early stage of negotiations the party for whom they are acting. It may be considered desirable to set out this relationship formally in writing for future reference.
— ensure that **all** confirmations make clear when a deal is done on an agency basis.
— when acting as agent for an unregulated principal, make clear at an early stage this qualification to potential counterparties; and include this on confirmations.

[1]There are two exceptions to this rule. The first covers the specialist inter-dealer brokers, involved primarily in US Treasury bills, notes and bonds, which act as matched principals. The other exception is when name-passing broking firms are investing their own money; in such transactions, brokers must make clear to the relevant counterparties that they are acting as principals.

- **Role of brokers**

29. Typically the role of the specialist wholesale market broking firms in London supervised as such by the Bank is to act as **arrangers** of deals.[1]

They:

— bring together counterparties on mutually acceptable terms and pass names to facilitate the conclusion of a transaction.

— receive payment for this service in the form of brokerage (except where a prior explicit agreement between the management of all parties to a deal provides otherwise).

— are not permitted, even fleetingly, to act as principal in a deal (even on a 'matched principal' basis), or to act in any discretionary fund management capacity.[1]

30. It is accepted that, in providing the service specified in the previous paragraph, individual brokers may be called upon to give advice or express opinions, usually in response to requests from individual dealers. While brokers should be mindful of the need not to reveal confidential information about the market activities of individual clients, there is no restriction on brokers passing, or commenting, on general information which is in the public domain. Equally, there is no responsibility upon a broker to volunteer general information of this type. Where information is sought or volunteered individual brokers should exercise particular care. For instance, brokers do not have sufficient information to be qualified to advise principals on the creditworthiness of specific counterparties and to do so is not their role.

III. CONTROLS

It is essential that Management have in place, and review regularly, appropriate control procedures which their dealing and other relevant staff must follow.

Know your counterparty

It is necessary for a variety of reasons, including firms' own risk control and the need to meet their legal obligations (e.g. on money laundering) for firms to undertake basic 'know their counterparty' checks before dealing in any products covered by this Code.

---

[1]The relationship between an institution offering a discretionary or advisory management service and its clients in any of the financial products described in the box on page 2 [pages 818–19 of this text] falls outside the scope of this Code and, if it constitutes investment business within the terms of the Financial Services Act 1986, should be conducted in accordance with the requirements of the relevant Self-Regulating Organisation.

Before agreeing to establish a dealing relationship in any of these wholesale market products, core principals should be mindful of any reputational risks which might arise as a result, and whether these risks might be greater when undertaking such transactions with non-core principals. In the absence of firm evidence to the contrary, non-core principals should be regarded as end-users (i.e. 'customers') of the wholesale markets.

31. In order to minimize the risks which they face it is desirable for core principals to have in place a clearly articulated approval process for their dealers and salespersons to follow before dealing for the first time in any wholesale market product with counterparties. This process, which should be appropriately monitored by management, should apply both when granting an initial dealing line for a product, and subsequently if changing or extending it to other wholesale products. Such a process might include the following considerations, which will need to be tailored to the type of transaction being considered.

- **With all counterparties**
  - What information is available to the core principal on the legal capacity of the counterparty to undertake such transactions? Is this information sufficient to make an informed decision on the legal risks it might face if it undertakes such business with the counterparty?
- **With customers**
  - Who initiated the request for the product relationship? Might this decision have been influenced by any product advice given by the core principal?
  - If advice is given was this subject to a written agreement between the parties; if not, should it be? Are both parties clear what reliance the customer is placing upon that advice?
  - What, if any, are the legal responsibilities the core principal might owe to the customer to whom advice is given in subsequently undertaking transactions in that product? For instance, management might ask itself if it is being asked to advise on the customer's whole portfolio—which might put it in a different legal position than if it were advising on only part of the portfolio.
  - Are there potential conflicts between the firm's interests and those of the potential customer? If there are how should they be managed; and does the customer need to be alerted?
  - Have appropriate legal agreements between the core principal and the customer been enacted? Do they make clear the respective responsibilities of both parties for any losses? Do they make clear which party is responsible for decisions to close-out trades undertaken?

32. **Procedures should be in place to ensure that the information available to banks and other core principals,** upon which they will base their judgement on whether or not to open/extend a dealing relationship with a particular customer, **is carefully assessed on a broad product by product basis.**

33. Once a customer dealing relationship has been established in one, or more, wholesale market product(s) it is **strongly recommended that management at both parties periodically review it,** against the above criteria. It is also in their own interest for core principals to review periodically the totality of their business relationship with each customer against the same criteria.

- **Additional arrangements for small investors**

The Bank believes that it is in the interest of banks and other listed institutions for management to consider most carefully whether to grant or extend dealing facilities in OTC wholesale market products to 'small investors' (i.e. individuals or small business investors as defined under SFA rules).

34. The expectation at the time the FSA was introduced was that individuals (or other small investors) would not normally be dealing in the wholesale OTC markets, which are primarily for core principals and other professionals such as large corporates, that regularly use the markets and which should have professionally trained staff able to undertake such transactions on their behalf.

35. It is more likely, therefore, that small investors will ask for **advice** on the particular product being considered (for instance in terms of its risk profile, how this might differ from exchange traded instruments with which they might be more familiar, or how to value its worth over time, etc). It is the Bank's view (shared by the SIB) that where this is so they should not automatically be granted a new or extended dealing line for this product. If the product being considered is a derivative and/or leveraged, the Bank believes that it is in the interest of banks and other listed institutions to have in place a written agreement, which makes clear which products are concerned and the extent to which any reliance can be placed by the small investor on the advice given.

36. Where an FSA exempt product is involved (items 6–16 in the box on page 3)[1] small investors should also be advised that by seeking to conduct such business with a s43 listed institution they would not have the protection of the FSA. The provisions set out in paragraph 21 above would apply.

[1]Pages 818–19 of this text.

37. The Bank believes it prudent for core principals to maintain, as accurately as they can, records of conversations—both internal or with the investor—material to their relationship. Where these are in written form, records must be kept in line with statutory requirements. Where tapes are the only record of specific transactions, management should consider very carefully whether some or all of these should be retained for a similar length of time to written records.

Dealing mandates

38. There has been growing interest in the use of dealing mandates as a means of clarifying the extent of a relationship between core principals and their customers, and their respective responsibilities. That in turn could help reduce the scope for errors. In the Bank's view it is appropriate for core principals to consider the merits of establishing dealing mandates to govern their relationship with non-core principals, but it is unlikely that mandates would be necessary between core principals. When deciding whether to initiate a mandate it is important that proper consideration is given by both parties to the manner in which the mandate is to be structured and subsequently administered.

39. It is good practice for both parties to agree what the mandate should and should not cover. To aid this process associations like the ACT and BBA may be able to guide their members on common practice. Where a mandate has been initiated, both parties should review it periodically; as a general rule, the onus is on the counterparty to notify the core principal promptly of any change necessary to an existing mandate.

40. While they can have a useful role in improving internal controls dealing mandates should **not** be used as a vehicle to pass all responsibility to another counterparty. They should not, therefore, weaken the standard set out in paragraph 16—that all firms will be held responsible for the actions of their staff. Firms must, in particular, ensure that any individual who commits the firm to a transaction has the necessary authority to do so, and is aware of the term of any mandate that has been agreed.

Confidentiality

41. Confidentiality is essential for the preservation of a reputable and efficient market place. Principals and brokers share equal responsibility for maintaining confidentiality. Principals or brokers should not, without explicit permission, disclose or discuss, or apply pressure on others to disclose or discuss, any information relating to specific deals which have been transacted, or are in the process of being arranged, except to or with the parties directly involved (and, if necessary, their advisers) or where

this is required by law or to comply with the requirements of a supervisory body.

42. Where confidential or market sensitive information is routinely shared by a London based firm with other branches/subsidiaries within its group it is for management to review periodically if this is appropriate. Where it is, the Bank believes that London management should be responsible and accountable for how such information is subsequently controlled—in particular they should make clear that such information should **at all times** continue to be treated as being subject to the confidentiality provisions of the Code. It is a responsibility of management to ensure that all relevant personnel are aware of, and observe, this fundamental principle.

43. Care should be taken over the use of open loudspeakers in both brokers' offices and principals' dealing rooms to ensure that they do not lead to breaches of confidentiality.

44. Situations arise where sales/marketing staff from core principals visit the offices of their customers; during such visits the customer may wish to arrange a transaction via the sales/marketing representative. Subject to proper controls this is perfectly acceptable. However, individual dealers or brokers should **not** visit each others' dealing rooms except with the express permission of the management of both parties. In particular a principal's dealer should **not** deal from within the offices of a broker or another principal. Brokers should never conduct business from outside their own offices. The only exception to these general rules might be when it is necessary for two unconnected institutions to share the same facilities as part of their agreed contingency arrangements. In such circumstances management should ensure appropriate arrangements are in place to protect counterparty confidentiality.

45. A principal should not place an order with a broker with the intention of ascertaining the name of a counterparty in order to make direct contact to conclude the deal; neither should direct contact be made to increase the amount of a completed trade arranged through a broker.

Location of back office functions

46. There is a growing trend towards locating front and back office functions in physically separate locations; indeed a number of the branches of international banks in London have relocated and consolidated their back office functions in their home country. Others have back offices outside London. The Bank's view is that there should be no objection to banks consolidating back offices in a single location, even if that were

overseas—provided that there are individuals in London with whom any deal or settlement queries can be resolved quickly.

47. At the same time the banking supervisors have reviewed whether it is still necessary in all cases, on control grounds, to maintain a physical segregation of back and front office staff within banks. They have concluded that whilst in most cases physical segregation is preferable, a lack of such segregation may be acceptable provided that it can be demonstrated that appropriate management controls are in place. For instance lack of segregation may be acceptable where computer logical access controls are in place. **Even so, it is essential that a strict segregation of duties between staff in the front and back office is maintained,** and especially that confirmations are sent direct to back office staff (see also paragraph 98 below).

Taping

48. Experience has shown that recourse to tapes proves invaluable to the speedy resolution of differences and disputes. The use of recording equipment in the offices of voice brokers and principals has become common; other means for monitoring 'conversations' are embodied within electronic broking systems now used in the markets. **The Bank strongly recommends taping by principals and brokers of all conversations by dealers and brokers** together with backoffice telephone lines used by those responsible for confirming deals or passing payment and other instructions. The Bank expects firms which it supervises to use tapes. Any which do not tape all their front plus relevant back office conversations should review this management policy periodically and be prepared to persuade the Bank that there are particular reasons for them to continue with such an approach. This review should be repeated annually. Failure to tape will normally count against a firm if it seeks to use the arbitration process described in paragraph 120 to settle a difference, or is the subject of a complaint.

49. When initially installing tape equipment, or taking on new clients or counterparties, firms should take the necessary steps to inform them that conversations will be recorded. **Tapes should be kept for at least two months, and preferably longer.** Experience suggests that, with the growing involvement of the private banking divisions within core principals in selling wholesale products to small investors, taping of all conversations by salesmen/account officers in these areas is in the interests of core principals. The longer tapes are retained the greater the chances are that any subsequent disputes over transactions or where advice has been given, can be resolved satisfactorily. **Tapes which cover any transaction about which there is a dispute should be retained until the problem**

has been resolved. Management should ensure that access to taping equipment and tapes, whether in use or in store, is strictly controlled so that they cannot be tampered with.

Deals at non-current rates

There is now widespread recognition that, as a general rule, deals at non-market rates should not be undertaken.

50. Banks and other listed firms are strongly discouraged from undertaking deals involving rolling-over an existing contract at the original rate. These should only be undertaken, if at all, on rare occasions and then after most careful consideration by both parties and approval, on a deal by deal basis, by their senior management. Senior management must ensure that proper procedures are in place to identify and bring to their attention all such deals **when they are proposed** so that they can be made fully aware of the details before reaching a decision on whether a particular trade should go ahead on this basis. Before reaching such a decision, senior management should seek written confirmation from the counterparty, also at senior management level, of the reasons for the transaction. This is essential not only because of the potential credit risk implications of rolling-over deals at original rates but also because failure to use current rates could result in the principal unknowingly participating in the concealment of a profit or loss, or in perpetration of a fraud. In order to provide a clear audit trail, there should be an immediate exchange of letters between the senior managements of both parties to any such deals to demonstrate that the above procedures have been followed.

51. However, if management accept that the application of non-market rates can be necessary to create deal structures which satisfy the legitimate requirements of counterparties, they should ensure proper controls are in place to prevent such arrangements from concealing fraud, creating unacceptable conflicts of interest, or involving other illegal activity. It is particularly important to ensure that there is no ambiguity in such transactions over the amounts which each counterparty is to pay and receive. It should, for instance, be possible to demonstrate from the documentation available to both parties that the combination of cashflows, coupons, and foreign exchange rates etc., used in such transactions produces a result that is consistent with the current market price for a straightforward transaction of similar maturity. **It is therefore essential that appropriate documentation is in place before any such deals are undertaken and that this is reviewed, by senior management, regularly so that they can satisfy themselves whether it remains appropriate to undertake further transactions on this basis.**

52. A specific area where there is sometimes pressure to conduct deals at non-current rates is in the foreign exchange market. In particular pressure can be placed on dealers undertaking a foreign exchange swap to avoid the immediate fixing of the spot price underlying the trade. **This practice is judged by practitioners in the London market to be unethical and is not appropriate practice for UK based institutions. Spot rates should be determined immediately after completion of the foreign exchange swap transaction.**

Dealing with unidentified principals

53. There has been a growing trend towards discretionary management companies dealing in wholesale market products on behalf of their clients. For its own commercial reasons a fund manager may not wish to divulge the name of its client(s) when concluding such deals. Since this practice raises important considerations, particularly in terms of banks' ability to assess their credit risk to particular counterparties and to meet supervisory requirements on large exposures, the Bank is in discussions with the relevant market associations about it; and may in due course seek views from other supervisors in Basle on this practice. In the interim, before any institution transacts business on this basis its senior management should decide, as a matter of policy, whether they judge it appropriate to do so. In doing so, they should consider all the risks involved. They should fully document the decision which they reach.

After-hours dealing

54. Extended trading after normal local hours has become accepted in some markets, most notably foreign exchange. Dealing after-hours into other centres forms an integral part of the operations of many firms both in London and elsewhere. Such dealing can involve additional hazards—whether undertaken direct or via a broker. For example, when dealing continues during the evening from premises other than the principals' dealing rooms, one of the principals involved might subsequently forget, or deny, having done a deal. Management should therefore issue clear guidelines to their staff, both on the kinds of deal which may be undertaken in those circumstances and on the permitted limits of any such dealing. All deals should be confirmed promptly—preferably by telex or similar electronic message direct to the counterparty's offices—and carefully controlled when arranged off-premises. Management should consider installing answerphone facilities in the dealing area which dealers should use to record full details of all off-premises trades. These should be processed promptly on the next working day.

Stop-loss orders

55. Principals may receive requests from branches, customers and correspondents to execute transactions—for instance to buy or sell a currency—if prices or rates should reach a specified level. These orders, which include stop-loss and limit orders from counterparties desiring around-the-clock protection for their own positions, may be intended for execution during the day, overnight, or until executed or cancelled. Management should ensure that the terms of such orders are explicitly identified and agreed, and that there is a clear understanding with the counterparty about the obligation it has assumed in accepting such orders. Moreover, management needs to establish clear policies and procedures for its traders who accept and execute stop-loss and limit orders. Management should also ensure that any dealer handling such an instruction has adequate lines of communication with the counterparty so that the dealer can reach authorized personnel in case of an unusual situation or extreme price/rate movement.

Conflicts of interest

- **Dealing for personal account**

56. Management should consider carefully whether their employees should be allowed to deal at all for own account in any of the products covered by this Code. Where allowed by management, it is their responsibility to ensure that adequate safeguards are established to prevent abuse. These safeguards should reflect the need to maintain confidentiality with respect to non-public price-sensitive information and to ensure that no action is taken by employees which might adversely affect the interest of the firm's clients or counterparties.

- **Deals using a connected broker**

57. Brokers have a legal obligation to disclose the nature and extent of any material conflict between their own interests and their responsibilities to clients. To safeguard the independence of brokers they should give all their clients formal written notification of any principal(s) where a material connection exists (unless a client explicitly waives its rights to this information in writing); and notify any subsequent changes to this list of principals as they occur. For the purposes of this Code, a material connection would include situations where the relationship between the parties could have a bearing on the transaction or its terms, as a result for example of common management responsibilities or material shareholding links, whether direct or indirect. The Bank regards a shareholding of 10% or more in a broker as material; but, depending on the circumstances, a smaller holding may also represent a material connection.

58. Any deals arranged by a broker involving a connected principal must be at arm's length (i.e. at mutually agreed rates which are the same as those prevailing for transactions between unconnected counterparties).

Marketing and incentives

59. When listed institutions are operating within the boundaries of the Section 43 arrangements, they will not be subject to advertising or cold-calling rules since these would be inappropriate in such professional markets. Nevertheless listed institutions should take care to ensure that any advertisements for their services within the exempt area are directed so far as possible towards professionals.

60. In recent years a number of foreign exchange electronic broking services have begun operating in London. Understandably such firms have considered a range of marketing arrangements, in the form of incentives, to generate liquidity in their systems. After consulting through the Joint Standing Committee it was concluded that the principle that brokers should not make payments to banks for using their services should be strictly maintained. As with conventional voice brokers, the provision of discount arrangements is a legitimate marketing technique, even if these involve cross-product subsidisation between different parts of the same group.

Entertainment, gifts and gambling

61. Management or employees must neither offer inducements to conduct business, nor solicit them from the personnel of other institutions. However it is recognized that entertainment and gifts are offered in the normal course of business and do not necessarily constitute inducements. Nevertheless, this is an area where the Bank receives a surprisingly high number of complaints about the potentially excessive nature of entertainment being offered. In response the Bank consulted practitioners during 1994 on how best to help facilitate a consistent approach across the London market. This reconfirmed that management should have a clearly articulated policy towards the giving/receipt of entertainment (and gifts), and ensure it is properly observed. It should include procedures for dealing with gifts judged to be excessive but which cannot be declined without causing offence. The policy should be reviewed periodically. In developing and implementing its policy, management should have regard to the potential adverse impact on the reputation of the firm, and the London market generally, of any adverse comment/publicity generated by any entertainment (or gifts) given or received.

62. The following general pointers have been identified which management ought to consider including as part of their policy:

- — Firms should have in place arrangements to monitor the type, frequency and cost of entertainment and gifts. Periodic control reports should be made available to management.
- — Authorisation and control procedures should be clear and unambiguous in order to ensure proper accountability.
- — Policies should contain specific reference to the appropriate treatment for gifts (given and received). This policy should specifically preclude the giving (or receiving) of cash or cash convertible gifts.
- — In determining whether the offer of a particular gift or form of entertainment might be construed as excessive, management should bear in mind whether it could be regarded as an improper inducement, either by the employer of the recipient or the supervisory authorities. Any grey areas should be cleared **in advance** with management at the recipient firm(s).
- — Firms should not normally offer entertainment if a representative of the host company will not be present at the event.

63. These procedures should be drawn up bearing in mind that the activities of dealers of some of the principals active in the markets may be governed by statute. For instance, offering hospitality or gifts to officers and members of local authorities and other public bodies is subject to the provisions of legislation that carries sanctions under criminal law. One of the most onerous requirements of this legislation is that any offer or receipt of hospitality is, prima facie, deemed to be a criminal offence, unless the contrary is proved.

64. Similar guidelines should also be established on gambling with other market participants. **All these activities carry obvious dangers and, where allowed at all, it is strongly recommended that they are tightly restricted.**

Abused substances (including drugs and alcohol)

65. Management should take all reasonable steps to educate themselves and their staff about possible signs and effects of the use of drugs and other abused substances. The judgement of any member of staff using such substances is likely to be impaired; dependence upon drugs etc makes them more likely to be vulnerable to outside inducement to conduct business not necessarily in the best interests of the firm or the market generally and could seriously diminish their ability to function satisfactorily.

IV. DEALING PRINCIPLES AND PROCEDURES: A STATEMENT OF BEST PRACTICE

Scope

Deals in the London wholesale markets (defined by the products covered in the box on page 3)[1] should be conducted on the basis of this Code of Conduct.

66. Whilst this Code is designed for the London markets, its provisions may extend beyond UK shores, for example where a listed UK broker arranges a deal involving an overseas counterparty. Where deals involving overseas counterparties are to be made on a different basis in any respect, for example because of distinct local rules or requirements, this should be clearly identified at the outset to avoid any possible confusion.

Overseas market conventions

The trading of currency assets in London should follow recognised trading conventions that have been established internationally or in specific overseas markets, provided they do not conflict with the principles of this Code.

67. Where foreign currency-denominated short-term securities issued overseas are traded in London, there may be important differences in dealing practice compared with the trading of London instruments, partly reflecting the way the instruments are traded in their domestic markets. The London Code is intended to be complementary to any generally accepted local standards and practices for such instruments traded in London. The Bank would expect firms trading these instruments in London to abide by any such local conventions.

Procedures

- **Preliminary negotiation of terms**

Firms should clearly state at the outset, prior to a transaction being executed, any qualifying conditions to which it will be subject.

68. Typical examples of qualifications include where a price is quoted subject to the necessary credit approval; finding a counterparty for matching deals; or the ability to execute an associated transaction. For instance principals may quote a rate which is 'firm subject to the execution of a hedge transaction'. For good order's sake it is important that

[1]Pages 818–19 of this text.

firms complete deals as quickly as possible; the onus is on both sides to keep each other informed of progress or possible delays. If a principal's ability to conclude a transaction is constrained by other factors, for example opening hours in other centres, this should be made known to brokers and potential counterparties at an early stage and before names are exchanged.

69. In the Euronote and commercial paper markets, principals should notify investors, at the time of sale, of their willingness or otherwise to repurchase paper. Investors should also be notified, before the sale, of any significant variation from the standard terms or conditions of an issue.

- **Undertaking derivative transactions with end-users (i.e. 'customers' of the market)**

It is important, before derivative transactions are undertaken with a customer, that dealers are satisfied that appropriate 'know your counterparty' procedures (see section III above) have been implemented for the product under consideration.

70. When a core principal is dealing with any customer of the market in leveraged or derivative products it is good practice for its dealers to assist their opposite number by using clear concise terminology. It is however the responsibility of each party involved to seek clarification, before concluding a deal, on any points about which they are not clear. Each party should also consider whether it would be helpful for the core principal to send by electronic means (telex or fax) a pre-deal message setting out the terms upon which the deal will be priced and agreed by both parties. While this may not be judged appropriate for some customers (e.g. an experienced large corporate), **it is likely to be helpful to send pre-deal messages to small investors (as defined earlier)**. Such a message may also be particularly useful, for instance, where the product involved is relatively new to the customer; or where the individual dealer acting on behalf of the customer is not the regular contact point for undertaking such trades with that customer. The sending or receipt of such a message is not a substitute for the confirmation procedures described below.

71. The existence, or not, of such a message should not however be taken as undermining in any way the principle that each party must accept responsibility for entering into such trades and any losses that they might incur as a result of doing so. There are, of course, circumstances in which this principle might be brought into question; for instance if the dealer at the core principal had deliberately misled the customer by knowingly providing false and/or inaccurate information at the time the deal was being negotiated. It is therefore very important that great care is taken not to mislead or misinform.

72. To help minimise the scope for error and misunderstanding the Bank strongly recommends that management require their dealers to use standard pre-deal check lists of the key terms that they need to agree when entering into leveraged and/or derivative transactions.

- **Firmness of quotation**

All firms, whether acting as principal, agent or broker, have a duty to make absolutely clear whether the prices they are quoting are firm or merely indicative. Prices quoted by brokers should be taken to be firm in marketable amounts unless otherwise qualified.

73. A principal quoting a firm price (or rate) either through a broker or directly to a potential counterparty is committed to deal at that price (or rate) in a marketable amount provided the counterparty name is acceptable. In order to minimise the scope for confusion where there is no clear market convention, dealers quoting a firm price (rate) should indicate the length of time for which their quote is firm.

74. It is generally accepted that when dealing in fast moving markets (like spot forex or currency options) a principal has to assume that a price given to a broker is good only for a short length of time—typically a matter of seconds. However, this practice would be open to misunderstandings about how quickly a price is deemed to lapse if it were adopted when dealing in generally less hectic markets, for example the forward foreign exchange or deposit markets, or when market conditions are relatively quiet. Since dealers have prime responsibility for prices put to a broker, the onus in such circumstances is on dealers to satisfy themselves that their prices have been taken off, unless a time limit is placed by the principal on its interest at the outset (e.g. 'firm for one minute only'). Otherwise, the principal should feel bound to deal with an acceptable name at the quoted rate in a marketable amount.

75. For their part brokers should make every effort to assist dealers by checking from time to time with them whether their interest at particular prices (rates) is still current. They should also do so when a specific name and amount have been quoted.

76. What constitutes a marketable amount varies from market to market but will generally be familiar to practitioners. A broker, if quoting on the basis of small amounts or particular names, should qualify the quotation accordingly. Where principals are proposing to deal in unfamiliar markets through a broker, it is recommended that they first ask brokers what amounts are sufficient to validate normal market quotations. If their interest is in a smaller amount, this should be specified by the principal when initially requesting a price from or offering a price to the broker.

77. In the swap market, considerable use is made of 'indicative interest' quotations. When arranging a swap an unconditional firm rate will only be given where a principal deals directly with a client, or when such a principal has received the name of a client from a broker. A principal who quotes a rate or spread as 'firm subject to credit' is bound to deal at the quoted rate or spread if the name is consistent with a category of counterparty previously identified for this purpose (see also paragraph 82 below). The only exception is where the particular name cannot be accepted, for example if the principal has reached its credit limit for that name, in which case the principal will correctly reject the transaction. It is not an acceptable practice for a principal to revise a rate which was 'firm subject to credit' once the name of the counterparty has been disclosed. Brokers and principals should work together to establish a range of institutions for whom the principal's rate is firm subject to credit.

- **Concluding a deal**

Principals should regard themselves as bound to a deal once the price and any other key commercial terms have been agreed. Oral agreements are considered binding. However, holding brokers unreasonably to a price is viewed as unprofessional and should be discouraged by management.

78. Where quoted prices are qualified as being indicative or subject to negotiation of commercial terms, principals should normally treat themselves as bound to a deal at the point where the terms have been agreed without qualification. Oral agreements are considered binding; the subsequent confirmation is evidence of the deal but should not override terms agreed orally. The practice of making a transaction subject to documentation is **not** good practice (see also paragraphs 107–109). In order to minimize the likelihood of disputes arising once documentation is prepared, firms should make every effort to agree all material points quickly during the oral negotiation of terms, and should include these on the confirmation. Any remaining details should be agreed as soon as possible thereafter.

79. Where brokers are involved, it is their responsibility to ensure that the principal providing the price (rate) is made aware immediately it has been dealt upon. As a general rule a deal should only be regarded as having been 'done' where the broker's contact is positively acknowledged by the dealer. A broker should never assume that a deal is done without some form of oral acknowledgement from the dealer. Where a broker puts a specific proposition to a dealer for a price (e.g. specifying an amount and a name for which a quote is required), the dealer can reasonably expect to be told almost immediately by the broker whether the price has been hit or not.

- **Passing of names by brokers**

Brokers should not divulge the names of principals prematurely, and certainly not until satisfied that both sides display a serious intention to transact. Principals and brokers should at all times treat the details of transactions as absolutely confidential to the parties involved (see paragraph 41 above).

80. To save time and minimise frustration, principals should wherever practicable give brokers prior indication of counterparties with whom, for whatever reason, they would be unwilling to do business (referring as necessary to particular markets or instruments). At the same time brokers should take full account of the best interests and any precise instructions of the client.

81. To save subsequent awkwardness, principals (including agents) have a particular obligation to give guidance to brokers on any particular features (maturities etc) or types of counterparty (such as non-financial institutions) which might cause difficulties. In some instruments, principals may also wish to give brokers guidance on the extent of their price differentiation across broad categories of counterparties. Where a broker is acting for an unlisted (or unsupervised) name he should disclose this fact as soon as possible; the degree of disclosure required in such a case will usually be greater. For instance, credit considerations may require that such names be disclosed to a listed principal first (as in the swap market), in order that the listed principal may quote a rate at which it is committed to deal. Equally, disclosure of difficult names may be necessary since this may influence the documentation.

82. In all their wholesale market business, brokers should aim to achieve a mutual and immediate exchange of names. However, this will not always be possible. There will be times when one principal's name proves unacceptable to another and the broker will quite properly decline to divulge by whom it was refused. This may sometimes result in the principal whose name has been rejected feeling that the broker may in fact have quoted a price (rate) which it could not in fact substantiate. In such cases, the Bank will be prepared to establish with the reluctant principal that it did have business to do at the quoted price and the reasons why the name was turned down, so that the aggrieved party can be assured the original quote was valid without, of course, revealing the reluctant party's name.

83. In the sterling and currency deposit markets, it is accepted that principals dealing through a broker have the right to turn down a name wishing to take deposits; this could therefore require predisclosure of the name before closing the deal. Once a lender has asked the key question

'who pays', it is considered committed to do business at the price quoted with that name, or an alternative acceptable name if offered immediately. The name of a lender shall be disclosed only after the borrower's name has been accepted by the lender. Conversely, where a borrower is taking secured money there may be occasions when it will wish to decline to take funds, through a broker, when the lender's name is passed.

84. In the case of instruments like CDs, where the seller may not be the same entity as the issuer, the broker shall first disclose the issuer's name to the potential buyer. Once a buyer has asked 'whose paper is it', the buyer is considered committed to deal at the price quoted. Once the buyer asks 'who sells' it is considered committed to deal with the particular seller in question (or an alternative acceptable name, so long as this name is immediately shown to the buyer by the broker). The name of the buyer shall be disclosed only after the seller's name has been accepted by the buyer. The seller has the right to refuse the particular buyer, so long as it is prepared at that time to sell the same amount at the same price to an alternative acceptable name immediately shown to it by the broker.

85. In the CD markets a price quoted is generally accepted as good for any name 'on the run'.

- **Use of intermediaries**

Brokers must not interpose an intermediary in any deal which could take place without its introduction.

86. An intermediary should only be introduced by a broker where it is strictly necessary for the completion of a deal, most obviously where a name switch is required because one counterparty is full of another's name but is prepared to deal with a third party. Any fees involved in transactions involving intermediaries must be explicitly identified by the broker and shown on the relevant confirmation(s).

87. Where a broker needs to switch a name this should be undertaken as promptly as possible, bearing in mind that this may take longer at certain times of the day; or if the name is a particularly difficult one; or if the deal is larger than normal. In no circumstances should a deal be left overnight without acceptable names having been passed.

- **Confirmation procedures**

Prompt passing, recording and careful checking of confirmations is vital to minimise the possibility of errors and misunderstanding whether dealing direct or through brokers. Details should be passed as soon as practicable after deals have been done and checked upon receipt. The passing of details in batches is not recommended. For markets where standard terms are applicable e.g. under standard documentation, it is

recommended that confirmations conform to the formats specified for the market or instrument concerned.

(a) Oral deal checks

An increasing number of practitioners find it helpful to undertake oral deal checks at least once a day, especially when using a broker.

88. Particularly when dealing in faster moving markets like foreign exchange, but also when dealing in other instruments which have very short settlement periods, many principals now request regular oral deal checks—whether dealing through brokers or direct—prior to the exchange and checking of a written or electronically dispatched confirmation. Their use can be an important means of helping to reduce the number and size of differences particularly when dealing through brokers or for deals involving non-London counterparties. It is for each firm to agree with its broker(s) whether or not it wishes to be provided with this service; and if so, how many such checks a day it requires. When arbitrating in disputes, the Bank will take into account the extent to which principals have sought to safeguard their interests by undertaking oral checks.

89. If a single check is thought to be sufficient, the Bank sees merit in this being undertaken towards the end of the trading day as a useful complement, particularly where late deals are concerned, to the process of sending out and checking confirmations.

90. As a matter of common sense, the broker should always obtain acknowledgement from a dealer on completion of the check that all the deals have been agreed or, if not, that any identified discrepancies are resolved as a matter of urgency. Lack of response should not be construed as acknowledgement.

(b) Written/electronic confirmations

In all markets, the confirmation provides a necessary final safeguard against dealing errors. Confirmations should be dispatched and checked carefully and promptly, even when oral deal checks have been undertaken. The issue and checking of confirmations is a back-office responsibility which should be carried out independently from those who initiate deals.

91. A confirmation of each deal must be sent out without delay. This is particularly essential if dealing for same day settlement. As a general rule the Bank believes all participants in the wholesale markets should have, or be aiming to have, in place the capability to dispatch confirmations so that they are received and can be checked within a few hours of when the deal was struck. Where the products involved are more com-

plex, and so require more details to be included on the confirmation, this may not be possible; nevertheless it is in the interest of all concerned that such deals are confirmed as quickly as is practicable. The Bank recommends that principals should enquire about any confirmations which have not been received within the expected timescale.

92. It is not uncommon in the derivatives markets, and perfectly acceptable if the two principals involved agree, for only **one** party (rather than both) to the deal to send out a confirmation. But where this is so, it is imperative not only that the recipient checks it promptly, but that it also in good time responds to the issuer of the confirmation agreeing/querying the terms. For good order's sake it would also be imperative that the issuer of the confirmation has in place procedures for chasing a response if one is not forthcoming within a few hours of the confirmation being sent.

93. All confirmations should include the trade date, the name of the other counterparty and all other details of the deal, including where appropriate the commission charged by the broker. Some principals include their own terms and conditions of trading on their written confirmations. To avoid misunderstandings, any subsequent changes should be brought specifically to the attention of their counterparties.

94. In many markets, it is accepted practice for principals to confirm directly all the details of transactions arranged through a broker; the broker should nevertheless also send a confirmation to each counterparty.

95. All principals are reminded that the prompt sending and checking of confirmations is also regarded as best practice in deals not arranged through a broker, including those with corporates and other customers.

96. Wherever practicable the Bank wishes to discourage the practice in some markets of sending two confirmations (e.g. an initial one by telex, fax or other acceptable electronic means) followed by a written confirmation, which if posted could easily not arrive until after the settlement date and could cause confusion and uncertainty. For this reason, the Bank believes that wherever practicable a single confirmation should be sent promptly by each party, if possible by one of the generally accepted electronic means now available (notably the ACS system, SWIFT, fax or telex). Where this is not practicable, for instance in more complex derivative transactions, firms should indicate (e.g. on the preliminary confirmation) that a more detailed written version is to follow. The Bank does not believe that it is good practice to rely solely on an oral check.

97. It is vital that principals check confirmations carefully and immediately upon receipt so that discrepancies can be quickly revealed and cor-

rected. Firms that check within a few hours of receipt would be complying with best practice.

98. As a general rule, confirmations should not be issued by or sent to and checked by dealers. This is a back-office function. Where dealers do get involved in these procedures they should be closely controlled. The most common instance where it may sometimes be thought helpful to mark a copy of the confirmation for the attention of the person who has arranged the deal, in addition to the back office, is in markets requiring detailed negotiation of terms (notably those involving contracts for differences). Certain automated dealing systems produce confirmations automatically; provided these are received in the back office no additional confirmation need be sent.

99. Particular attention needs to be paid by all parties when confirming deals in which at least one of the counterparties is based outside London, and to any consequential differences in confirmation procedure.

- **Payment/settlement instructions**

Instructions should be passed as quickly as possible to facilitate prompt settlement. The Bank strongly recommends the use of standard settlement instructions; their use can make a significant contribution to reducing both the incidence and size of differences arising from the mistaken settlement of funds.

100. The use of standard settlement instructions (SSIs) continues to increase in London. International acceptance of the benefits of many SSIs is an important next step. In order to facilitate still greater usage of SSIs the BBA now maintains a directory of London based institutions that use them. The Bank wishes to encourage firms that it supervises, that do not already do so, to draw up plans to move towards using SSIs as soon as possible. A major advantage of using SSIs is that they remove the need to confirm payment details by phone.

101. The guidelines set out in Schedule 2, which have been drawn up in consultation with practitioners, set out a framework which it is hoped principals will aim to adopt when using SSIs for wholesale market transactions. The guidance notes emphasise that SSIs should only be established via confirmed letter or authenticated SWIFT message, and **not** by SWIFT broadcast. While many firms comply with this guidance, difficulties have been encountered where some insist on using SWIFT broadcasts. Having raised the matter with SWIFT it is clear that broadcast messages remain unsuitable for the purpose of changing SSIs and are non-binding on recipients. SWIFT is currently looking at developing a new message for this purpose. In the interim, however, the majority view is that banks which receive notice from a counterparty of the amendment

of an SSI by a SWIFT broadcast should be free to act upon such notice if they so wish. They should seek authentication of the message by way of sending confirmation of the arrangement, making clear when and for what deals the new instructions will be implemented. Until that process is complete the original instructions will be deemed still to be operative.

102. It has been the practice in the domestic sterling market that brokers pass payment instructions. In view of the increasing use of SSIs, the domestic sterling market should be moving away from requiring this service from brokers. Brokers should therefore only be expected to pass payment instructions in very unusual circumstances or in certain deposit markets where the counterparty is a non-core principal (such as a local authority).

103. Similarly brokers do not pass payment instructions in the foreign exchange and currency deposits market where the counterparties are both in the UK. It is for banks to agree with brokers the basis on which they will be able to pass such instruction for deals using a non-UK counterparty; all such instructions should be passed with minimum delay. It is intended that, with the hoped for increasing use of SSIs internationally, brokers will cease providing payment instructions involving overseas counterparties in due course.

104. Where SSIs are not being used, principals should ensure that any alterations to original payment instructions, including the paying agent where this has been specifically requested, should be immediately notified direct to the counterparty. This notification should be supported by written, telex, or similar confirmation of the new instructions.

105. While it is important that payment instructions are passed quickly, it is equally important that principals have in place appropriate procedures for controlling the timing of their instructions to correspondent banks to release funds when settling wholesale market transactions. A recent survey by G-10 central banks suggested that there is a wide gap between the best and worst controls practised in the markets; failure to maintain effective controls over payment flows can significantly increase the risks that institutions face when dealing in the OTC wholesale markets.

- **Fraud**

106. There is a need for great vigilance by all staff against attempted fraud. This is particularly so where calls are received on an ordinary telephone line (usually in principal to principal transactions). As a precautionary measure, it is strongly recommended that details of all telephone deals which do not include pre-agreed standard settlement instructions

should be confirmed by telex or similar means without delay by the recipient, seeking an answer-back to ensure the deal is genuine.

- **Terms and documentation**

It is now common for wholesale market deals to be subject to some form of legal documentation binding the two parties to certain standard conditions and undertakings. The Bank endorses the use, wherever possible, of such documentation (which typically will take the form either of signed Master Agreements exchanged between the two parties or can take the form of standard Terms). Core principals should have procedures in place to enable documentation to be completed and exchanged as soon as possible.

107. It is in the interest of all principals to make every effort to progress the finalisation of documentation as quickly as possible. In some markets, such as repo, or in other circumstances such as those described in paragraphs 31 and 51, documentation should be in place before any deals are undertaken. More generally, however, the Bank believes the aim should be for documentation to be in place within three months of the first deal being struck. Failure to agree documentation within this timescale should cause management to review the additional risks that this might imply for any future deals with the counterparty concerned. Factors which may influence managements' views include whether they can take comfort on their legal position from the mutual confirmation of terms with a particular counterparty; or where the delay is in putting in place multiple master agreements for products that are, in the interim, subject to previously agreed documentation.

108. Some documentation in common usage provides for various options and/or modifications to be agreed by mutual consent. These must be clearly stated before dealing. Firms should make clear at an early stage, when trading any of the above mentioned products, if they are not intending to use standard terms documentation. Where changes are proposed these should also be made clear. For other wholesale instruments, where standard terms do not yet exist (e.g. barrier options), particular care and attention should be paid to the negotiation of terms and documentation.

109. Some outstanding transactions might still be subject to old documentation (e.g. the 1987 ISDA) that results in one-way payment provisions. The use of such provisions is **not** recommended. Banking supervisors worldwide have indicated that such transactions will not be eligible for netting for capital adequacy purposes and the Bank supports moves to amend such clauses where they are still in existence. Non-core principals are encouraged to co-operate in core principals in this objective.

- **Stock lending and repos**

Where sale and repurchase (or stock borrowing and lending) transactions are entered into, proper documentation and prior agreement of key terms and conditions are essential.

110. The Bank expects core principals to abide by the relevant codes drawn up by market practitioners. When undertaking stock lending transactions the Stock Borrowing and Lending Committee Code of Guidance should apply. With the advent of a gilt repo market the Gilt Repo Code of Best Practice should be adhered to.

111. The Gilt Repo Code will apply not only to gilt repo, but also to other transactions involving gilts which have similar effect and intent, including secured lending (of money and gilts) e.g. under the gilt-edged stock lending agreement; lending of gilts against collateral; and buy/sell-backs (whether or not under a Master Agreement). The Bank also believes that the general standards set down in the Gilt Repo Code will be relevant when undertaking other, non-gilt, repo activity covered by the London Code.

- **Assignments or transfers**

Assignments should not generally be undertaken without the consent of the parties concerned.

112. Assignments have become increasingly common in the derivatives market. Principals who enter into any wholesale market transaction with the intention of shortly afterwards assigning or transferring the deal to a third party should make clear their intention to do so when initially negotiating the deal. It is recommended that the confirmation sent by the principal should specify any intent to assign and give details of the procedure that will be used. The subsequent documentation should also make provision for assignment.

113. When a principal is intending to execute such a transfer it must obtain the consent of the transferee before releasing its name. If the principal proposes to use a broker to arrange the transfer, consent from the transferee for this to happen must also be obtained. The transferee has an obligation to give the principal intending to transfer sufficient information to enable the transaction to be conducted in accordance with the principles of best practice set out elsewhere in the Code. Where the transaction is conducted through a broker, this information should likewise be made available to him. In particular, the information from the transferee should include details of the type of credit the transferee is prepared to accept, and whether he is seeking any sort of reimbursement for the administrative costs that might be incurred. Principals and brokers

arranging a transfer or assignment should also agree the basis of pricing the transfer at an early stage of the negotiations. When arranging assignments, it is important for participants to observe the general principle set out elsewhere in the Code that there should be mutual disclosure of names. Finally it should be noted that proper, clear documentation is as important for transfers as for the origination of deals.

Settlement of differences

If all the procedures outlined above are adhered to, the incidence and size of differences should be reduced; and those mistakes which do occur should be identified and corrected promptly. Failure to observe these principles could leave those responsible bearing the cost, without limit on size or duration, of any differences which arise. Except in the foreign exchange market, all differences must be settled in cash.

114. In all the wholesale markets (including foreign exchange) if a broker misses a price he is required by the Bank to offer to close the deal at the next best price if held to the deal. The broker must then settle the difference arising by cheque (or, if both sides agree, points if it is a foreign exchange transaction); **principals should always be prepared to accept this cash settlement since to do otherwise would put the broker in breach of the Code. It is unprofessional for a dealer to refuse to accept a difference cheque and insist the deal is honoured;** individual brokers facing this situation should advise their senior management who, if necessary, should raise the matter with management of the client. The Bank is keen to be advised of any persistent offenders.

115. Where brokers are used to arrange derivative products like barrier options, they should not be held liable for disputes between principals that arise where there is a disagreement over whether a certain spot level has or has not been reached in sufficient quantity to trigger the option. Nor should brokers be cited as independent referees in such transactions unless they have explicitly agreed to do so before the deal is struck.

116. As noted above, the prompt despatch and checking of confirmations is of paramount importance. Non-standard settlement instructions should be particularly carefully checked, and any discrepancies identified promptly upon receipt, and notified direct to the counterparty, or to the broker (in circumstances described earlier).

117. Where difference payments arise because of errors in the payment of funds, principals are reminded that it is the view of the Bank and the Joint Standing Committees that they should not benefit from undue enrichment by retaining the funds. Technological developments have resulted in faster and more efficient mechanisms for the delivery and

checking of confirmations. This means that when brokers pass payment instructions that cannot be cross-checked against direct confirmation details, their liability in the event of an error should be limited to 24 hours from when the deal was struck. This limit on the broker's liability is not intended to absolve brokers of responsibility for their own errors; rather it recognises that once payments do go astray the broker is limited in what action it can directly take to rectify the situation.

118. In the foreign exchange and currency deposit markets arrangements have been drawn up to facilitate the payment of differences via the Secretary of the Foreign Exchange Joint Standing Committee.[1] In the foreign exchange market only, and only with the explicit consent of principals, brokers may make use of 'points' to settle differences. Even then their use will only be permitted if arrangements for management control, recording and reporting of points consistent with the requirements laid down by the Bank (see Annex 1)[2] have been established.

119. Listed broking firms must agree their own procedures with the Wholesale Markets Supervision Division of the Bank before using 'points.' The informal use of 'points' between individual dealers and brokers is not acceptable. Using 'points' in lieu of cash to settle differences is not permitted in any market other than foreign exchange. As a matter of prudent housekeeping, all differences should normally be settled within 30 days from the date the original deal was undertaken.

Arbitration procedure

120. The Bank is prepared to arbitrate in disputes between firms it supervises about the application of the Code, or current market practice, to specific transactions in wholesale market products. As a condition for doing so the Bank will expect the parties to have exhausted their own efforts to resolve the matter directly. All parties must then first agree to the Bank taking such a role and to accept its decision in full and final settlement of the dispute. In doing so, the Bank may draw on the advice and expertise of members of the Joint Standing Committees or other market practitioners as it feels appropriate. Requests for arbitration should be addressed to the Bank's Wholesale Markets Supervision Division. The Bank will not normally arbitrate in any dispute which is subject to, or is likely to be subject to, legal proceedings. Paragraphs 48 and 49 of the

[1]All requests for settlement via these arrangements should be marked for the attention of The Secretary, Foreign Exchange Joint Standing Committee, Bank of England Dealing Room (HO-G), Bank of England, Threadneedle Street, London EC2R 8AH. They should be accompanied by a written report of the circumstances resulting in the difference.

[2]The annexes are omitted from this text.

Code, on taping, and paragraphs 88–90, on oral deal checks, are especially relevant to firms considering recourse to these arrangements.

Commission/brokerage

Brokers' charges are freely negotiable. Principals should pay brokerage bills promptly.

121. Where the services of a broker are used it is traditional practice for an appropriate brokerage package to be agreed by the directors or senior management on each side. Any variation on a particular transaction from those previously agreed brokerage arrangements should be expressly approved by both parties and clearly recorded on the subsequent documentation; this should be the exception rather than the rule. Under no circumstances should a broker pay cash to a principal as an incentive to use its service (see also early section on Marketing).

122. Although brokers normally quote dealing prices excluding commission/brokerage charges, it is perfectly acceptable, and not uncommon, in some derivative markets for the parties to agree that the broker quotes rates gross of commission and separately identifies the brokerage charge. Equally there may be circumstances when the broker (or principal) and client may agree on an acceptable net rate; if so it is important that the broker (or principal) subsequently informs the client how that rate is divided between payments to counterparties and upfront commission. In such cases it is essential that all parties are quite clear that this division will be determined no later than the time at which the deal is struck; and that a record is kept.

123. The Bank is aware that some principals fail to pay due brokerage bills promptly. **This is not good practice** and can significantly disadvantage brokers since overdue payments are treated by the Bank, for regulatory purposes, as a deduction from their capital base.

Market conventions

Management should ensure that individual brokers and dealers are aware of their responsibility to act professionally at all times and, as part of this, to use clear, unambiguous terminology. This is even more important when dealing with non-core principals, whose staff may be less experienced in dealing in these markets.

124. The use of clear language is in the interests of all concerned. Management should establish internal procedures (including retraining if necessary) to alert individual dealers and brokers who act in different markets (or move from one market to another) both to any differences in terminology between markets and to the possibility that any particular

term could be misinterpreted. The use of generally accepted concise terminology is undoubtedly helpful. In those markets where standard terms and conditions have been published individual dealers and brokers should familiarise themselves with the definitions they contain.

125. Standard conventions for calculating the interest and proceeds on certain sterling and currency instruments, together with market conventions regarding brokerage, are set out in Schedule 1.

Market disruption/bank holidays

126. There have been instances of general disruption to the wholesale markets which have, in turn, resulted in interruptions to the sterling settlement systems and consequent delays in sterling payments. It has been agreed by the Joint Standing Committees that in such unexpected circumstances the Bank should determine and publish the interest rate(s) which parties to deals affected by such interruptions should use to calculate the appropriate interest adjustment (unless all the parties to the deal agree instead on some other arrangement—such as to continue to apply the existing rate of interest on the original transaction or as provided for in the relevant documentation). The Bank shall have absolute discretion in its determination of any interest rate(s), and shall not be required to explain its method of determining the same and shall not be liable to any person in respect of such determination.

127. Occasionally unforseen events mean that market participants will have entered into contracts for a particular maturity date only to find, subsequently, that that day is declared a public holiday. It is normal market practice in London to extend contracts maturing on a non-business day to the next working day. But to minimise possible disputes market participants may need to agree settlement arrangements for such deals with their counterparties in advance.

MARKET CONVENTIONS **Schedule 1**

1. Calculation of interest and brokerage in the sterling deposit market

- **Interest**

On CDs and deposits or loans this is calculated on a daily basis on a 365-day year.

Interest on a deposit or loan is paid at maturity, or annually and at maturity, unless special arrangements are made at the time the deal is concluded.

On secured loans the discount houses and Stock Exchange money brokers do not pay interest at intervals of less than 28 days. The current general practice is to calculate at the close of business on the penultimate working day interest outstanding on secured loans to the last working day of each calendar month and to pay the interest thereon on the last working day of the month.

- **Brokerage**

All brokerage is calculated on a daily basis on a 365-day year and brokerage statements are submitted monthly.

2. Calculation of interest in a leap year

The calculation of interest in a leap year depends upon whether interest falls to be calculated on a daily or an annual basis. The position may differ as between temporary and longer-term loans.

- **Temporary loans**

Because temporary loans may be repaid in less than one year (but may, of course, be continued for more than a year) interest on temporary money is almost invariably calculated on a daily basis. Thus any period which includes 29 February automatically incorporates that day in the calculation; in calculating the appropriate amount of interest, the number of days in the period since the last payment of interest is expressed as a fraction of a normal 365-day year, not the 366 days of a leap year, which ensures that full value is given for the 'extra' day.

Examples:

Assume last previous interest payment 1 February (up to and including 31 January) and date of repayment 1 April (in a leap year). Duration of loan for final interest calculation = 29 days (February) + 31 days (March) = 60 days.

Calculation of interest would be

$$P \times \frac{r}{100} \times \frac{60}{365} =$$

Assume no intermediate interest payments. Loan placed 1 March and called for repayment 1 March the following year (leap year). Total period up to and including 29 February = 366 days. Calculation of interest would be

$$P \times \frac{r}{100} \times \frac{366}{365} =$$

This is in line with banking practice regarding interest on deposits which is calculated on a 'daily' basis and no conflict therefore arises.

- **Longer-term loans**

The following procedure for the calculation of interest on loans which cannot be repaid in less than one year (except under a TSB or building society stress clause) was agreed between the BBA and the Chartered Institute of Public Finance and Accountancy on 12 December 1978.

(a) Fixed interest

The total amount of interest to be paid on a longer-term loan at fixed interest should be calculated on the basis of the number of complete calendar years running from the first day of the loan, with each day of any remaining period bearing interest as for 1/365 of a year.

Normal practice for the calculation of interest in leap years is to disregard 29 February if it falls within one of the complete calendar years. Only when it falls within the remaining period is it counted as an additional day with the divisor remaining at 365.

Example: 3½ year loan, maturing on 30 June of a leap year.

First 3 years' interest:

$$P \times \frac{r}{100} \times 3 =$$

Final 6 months' interest:

$$P \times \frac{r}{100} \times \frac{182}{365} =$$

Certain banks, however, require additional payment of interest for 29 February in all cases, and it was therefore agreed that:

both the original offer or bid, and the agent's confirmation, must state specifically if such payment is to be made; and

the documentation must incorporate the appropriate phraseology.

Interest on longer term loans should be paid half-yearly, on the half-yearly anniversary of the loan or on other prescribed dates and at maturity. **To calculate half-yearly interest payments** the accepted market formula is:

$$P \times \frac{r}{100} \times \frac{d}{365} =$$

where d = actual number of days.

Although, with the agreement of both parties, the following is sometimes used:

$$P \times \frac{r}{100} \times \frac{1}{2} =$$

(b) Floating rate

Interest on variable rate loans, or roll-overs, which are taken for a fixed number of years with the rate of interest adjusted on specific dates, should be calculated in the same manner as for temporary loans.

3. Brokerage and other market conventions in the foreign exchange and currency deposit markets

- **Brokerage**

(a) General (foreign exchange and currency deposits)

Brokerage arrangements are freely negotiable.

These arrangements should be agreed by directors and senior management in advance of any particular transaction.

(b) Currency deposits

Calculation of brokerage on all currency deposits should be worked out on a 360-day year.

Brokers' confirmations and statements relating to currency deposits should express brokerage in the currency of the deal.

In a simultaneous forward-forward deposit (for example one month against six months), the brokerage to be charged shall be on the actual intervening period (in the above example, five months).

- **Other Market Conventions**

Currency deposits

Length of the year

For the purpose of calculating interest, one year is in general deemed to comprise 360 days; but practice is not uniform in all currencies or centres.

Spreads and quotations

Quotations will normally be made in fractions, except in short-dated foreign exchange dealings, where decimals are normally used.

Call and notice money

For US dollars (and sterling), notice in respect of call money must be given before noon in London. For other currencies, it should be given before such time as may be necessary to conform with local clearing practice in the country of the currency dealt in.

4. Calculations in the foreign currency asset markets

- **Euro-commercial paper (and other such instruments)**

The net proceeds of short-term interest-bearing and discount Euro-commercial paper, on which interest is determined on a 360-day basis, are calculated in the same manner as those for short-term, interest-bearing and discount CDs.

Formula for non-interest bearing Euronotes quoted on a 'discount to yield' basis:

$$\frac{N}{1 + \left(\frac{Y}{100} \times \frac{M}{360}\right)} = \text{Purchase consideration}$$

where

N = Nominal amount or face value

Y = Yield

M = Number of days to maturity

Example:

A Euronote with a face value of US$5 million and with 90 days to run is sold to yield 7.23% per annum.

$$\frac{5{,}000{,}000}{1 + \dfrac{(7.23 \times 90)}{(36{,}000)}} = \$4{,}911{,}229.53$$

- **US Treasury bills (and other US discount securities such as bankers' acceptances and commercial paper)**

The quoted trading rates for such assets are discount rates. The price of the asset is calculated on the basis of a 360-day year.

The market price (Pm) on a redemption value of $100 can be calculated as follows:

$$Pm = 100 - \frac{(M \times D)}{(360)}$$

where

M = days to maturity or days held

D = discount basis (per cent).

GUIDELINES FOR EXCHANGING STANDARD SETTLEMENT INSTRUCTIONS (SSIs) — Schedule 2

These guidelines have been drawn up by the Bank of England in consultation with practitioners. While the parties to SSIs are free to agree changes to the detail on a bilateral basis, it is hoped that this framework will be useful and as such followed as closely as possible.

When **establishing** SSIs with a counterparty for the first time these should be appropriately authorised internally before being issued. It is desirable that SSIs be established by post (and issued in duplicate, typically under two authorised signatories). However authenticated SWIFT message can also be used if necessary.

Cancellation or amendment of a standard instruction should ideally be undertaken by authenticated SWIFT; tested telex is also an acceptable means when cancelling or making amendments. SWIFT broadcast is **not** an acceptable means for establishing, cancelling or amending SSIs.

A mutually agreed **period of notice** for changing SSIs should be given; typically this will be between 10 working days and one month. Some parties may also wish to provide for changes to be made at shorter notice in certain circumstances.

Recipients have a responsibility to acknowledge acceptance (or otherwise) of the proposed/amended SSI within the timescale agreed (see above). Failure to do so could result in a liability to compensate for any losses which result. In the case of written notification this should be undertaken by the recipient signing and returning the duplicate letter.

Recipients should also confirm the precise date on which SSIs will be activated (via SWIFT or tested telex).

Instructions should be issued for each currency and wholesale market product. Each party will typically nominate only one correspondent per currency for foreign exchange deals and one per currency for other wholesale market deals. The same correspondent may be used for foreign exchange and other wholesale market deals.

As a general rule, all outstanding deals, including maturing forwards, should be settled in accordance with the SSI in force at their value date (unless otherwise and explicitly agreed by the parties at the time at which any change to an existing SSI is agreed).

The SSI agreement for each business category should contain the following:

— the nature of the deals covered (for example whether they include same day settlement or only spot/forward forex deals).

— confirmation that a single SSI will apply for all such deals with the counterparty.

— the effective date.

— confirmation that it will remain in force 'until advised'.

— recognition that no additional telephone confirmation of settlement details will be required.

— recognition that any deviation from the SSI will be subject to an agreed period of notice.

When operating SSIs on this basis, the general obligations on both parties are to ensure that:

— they apply the SSI which is current on the settlement date for relevant transactions.

— confirmations are issued in accordance with the London Code of Conduct; the aim should be to send them out on the day a deal is struck.

Confirmations are checked promptly upon receipt in accordance with the London Code. Any discrepancies should be advised by no later than 3.00 pm on the business day following trade date, if not sooner.

[Annex 1 and 2 are omitted from this text.]

Appendix III
European Community Documents

Appendix III

1 EC Directive on Deposit-Guarantee Schemes

Council Directive[1]

30 May 1994

on deposit-guarantee schemes

(94/19/EC)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular the first and third sentences of Article 57(2) thereof,

Having regard to the proposal from the Commission,[2]

Having regard to the opinion of the Economic and Social Committee,[3]

Acting in accordance with the procedure referred to in Article 189b of the Treaty,[4]

Whereas, in accordance with the objectives of the Treaty, the harmonious development of the activities of credit institutions throughout the Community should be promoted through the elimination of all restrictions on the right of establishment and the freedom to provide services, while increasing the stability of the banking system and protection for savers;

Whereas, when restrictions on the activities of credit institutions are eliminated, consideration should be given to the situation which might arise if deposits in a credit institution that has branches in other Member States become unavailable; whereas it is indispensable to ensure a harmonized minimum level of deposit protection wherever deposits are located in the Community; whereas such deposit protection is as essential as the prudential rules for the completion of the single banking market;

[1] OJ No. L 135, 31.5.1994, p. 5.

[2] OJ No. C 163, 30.6.1992, p.6 and OJ No. C 178, 30.6.1993, p.14.

[3] OJ No. C 332, 16.12.1992, p. 13.

[4] OJ No. C 115, 26.4.1993, p. 96, and Decision of the European Parliament of 9 March 1994, OJ No. C 91, 28.3.1994, p. 85.

Whereas in the event of the closure of an insolvent credit institution the depositors at any branches situated in a Member State other than that in which the credit institution has its head office must be protected by the same guarantee scheme as the institution's other depositors;

Whereas the cost to credit institutions of participating in a guarantee scheme bears no relation to the cost that would result from a massive withdrawal of bank deposits not only from a credit institution in difficulties but also from healthy institutions following a loss of depositor confidence in the soundness of the banking system;

Whereas the action the Member States have taken in response to Commission recommendation 87/63/EEC of 22 December 1986 concerning the introduction of deposit-guarantee schemes in the Community[5] has not fully achieved the desired result; whereas that situation may prove prejudicial to the proper functioning of the internal market;

Whereas the Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC,[6] provides for a system for the single authorization of each credit institution and its supervision by the authorities of its home Member State, which entered into force on 1 January 1993;

Whereas a branch no longer requires authorization in any host Member State, because the single authorization is valid throughout the Community, and its solvency will be monitored by the competent authorities of its home Member State; whereas that situation justifies covering all the branches of the same credit institution set up in the Community by means of a single guarantee scheme; whereas that scheme can only be that which exists for that category of institution in the State in which that institution's head office is situated, in particular because of the link which exists between the supervision of a branch's solvency and its membership of a deposit-guarantee scheme;

Whereas harmonization must be confined to the main elements of deposit-guarantee schemes and, within a very short period, ensure payments under a guarantee calculated on the basis of a harmonized minimum level;

Whereas deposit-guarantee schemes must intervene as soon as deposits become unavailable;

---

[5] OJ No. L 33, 4.2.1987, p. 16.

[6] OJ No. L 386, 30. 12.1989, p. 1. Directive as amended by Directive 92/30/EEC, OJ No. L 110, 28.4.1992, p. 52.

Whereas it is appropriate to exclude from cover, in particular, the deposits made by credit institutions on their own behalf and for own account; whereas that should not prejudice the right of a guarantee scheme to take any measures necessary for the rescue of a credit institution that finds itself in difficulties;

Whereas the harmonization of deposit-guarantee schemes within the Community does not of itself call into question the existence of systems in operation designed to protect credit institutions, in particular by ensuring their solvency and liquidity, so that deposits with such credit institutions, including their branches established in other Member States, will not become unavailable; whereas such alternative systems serving a different protective purpose may, subject to certain conditions, be deemed by the competent authorities to satisfy the objectives of this Directive; whereas it will be for those competent authorities to verify compliance with those conditions;

Whereas several Member States have deposit-protection schemes under the responsibility of professional organizations, other Member States have schemes set up and regulated on a statutory basis and some schemes, although set up on a contractual basis, are partly regulated by statute; whereas that variety of status poses a problem only with regard to compulsory membership of and exclusion from schemes; whereas it is therefore necessary to take steps to limit the powers of schemes in this area;

Whereas the retention in the Community of schemes providing cover for deposits which is higher than the harmonized minimum may, within the same territory, lead to disparities in compensation and unequal conditions of competition between national institutions and branches of institutions from other Member States; whereas, in order to counteract those disadvantages, branches should be authorized to join their host countries' schemes so that they can offer their depositors the same guarantees as are offered by the schemes of the countries in which they are located; whereas it is appropriate that after a number of years the Commission should report on the extent to which branches have made use of this option and on the difficulties which they or the guarantee schemes may have encountered in implementing these provisions; whereas it is not ruled out that home Member State schemes should themselves offer such complementary cover, subject to the conditions such schemes may lay down;

Whereas market disturbances could be caused by branches of credit institutions which offer levels of cover higher than those offered by credit institutions authorized in their host Member States; whereas it is not appropriate that the level of scope of cover offered by guarantee schemes should become an instrument of competition; whereas it is therefore nec-

essary, at least during an initial period, to stipulate that the level and scope of cover offered by a home Member State scheme to depositors at branches located in another Member State should not exceed the maximum level and scope offered by the corresponding scheme in the host Member State; whereas possible market disturbances should be reviewed after a number of years, on the basis of the experience acquired and in the light of developments in the banking sector;

Whereas in principle this Directive requires every credit institution to join a deposit-guarantee scheme; whereas the Directives governing the admission of any credit institution which has its head office in a non-member country, and in particular the First Council Directive (77/780/EEC) of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions,[7] allow Member States to decide whether and subject to what conditions to permit the branches of such credit institutions to operate within their territories; whereas such branches will not enjoy the freedom to provide services under the second paragraph of Article 59 of the Treaty, nor the right of establishment in Member States other than those in which they are established; whereas, accordingly, a Member State admitting such branches should decide how to apply the principles of this Directive to such branches in accordance with Article 9(1) of Directive 77/780/EEC and with the need to protect depositors and maintain the integrity of the financial system; whereas it is essential that depositors at such branches should be fully aware of the guarantee arrangements which affect them;

Whereas, on the one hand, the minimum guarantee level prescribed in this Directive should not leave too great a proportion of deposits without protection in the interest both of consumer protection and of the stability of the financial system; whereas, on the other hand, it would not be appropriate to impose throughout the Community a level of protection which might in certain cases have the effect of encouraging the unsound management of credit institutions; whereas the cost of funding schemes should be taken into account; whereas it would appear reasonable to set the harmonized minimum guarantee level at ECU 20 000; whereas limited transitional arrangements might be necessary to enable schemes to comply with that figure;

Whereas some Member States offer depositors cover for their deposits which is higher than the harmonized minimum guarantee level provided

---

[7] OJ No. L 322, 17.12.1977, p. 30. Directive as last amended by Directive 89/646/ EEC, OJ No. L 386, 30.12.1989, p. 1.

for in this Directive; whereas it does not seem appropriate to require that such schemes, certain of which have been introduced only recently pursuant to recommendation 87/63/EEC, be amended on this point;

Whereas a Member State must be able to exclude certain categories of specifically listed deposits or depositors, if it does not consider that they need special protection, from the guarantee afforded by deposit-guarantee schemes;

Whereas in certain Member States, in order to encourage depositors to look carefully at the quality of credit institutions, unavailable deposits are not fully reimbursed; whereas such practices should be limited in respect of deposits falling below the minimum harmonized level;

Whereas the principle of a harmonized minimum limit per depositor rather than per deposit has been retained; whereas it is therefore appropriate to take into consideration the deposits made by depositors who either are not mentioned as holders of an account or are not the sole holders; whereas the limit must therefore be applied to each identifiable depositor; whereas that should not apply to collective investment undertakings subject to special protection rules which do not apply to the aforementioned deposits;

Whereas information is an essential element in depositor protection and must therefore also be the subject of a minimum number of binding provisions; whereas, however, the unregulated use in advertising of references to the amount and scope of a deposit-guarantee scheme could affect the stability of the banking system or depositor confidence; whereas Member States should therefore lay down rules to limit such references;

Whereas, in specific cases, in certain Member States in which there are no deposit-guarantee schemes for certain classes of credit institutions which take only an extremely small proportion of deposits, the introduction of such a system may in some cases take longer than the time laid down for the transposition of this Directive; whereas in such cases a transitional derogation from the requirement to belong to a deposit-guarantee scheme may be justified; whereas, however, should such credit institutions operate abroad, a Member State would be entitled to require their participation in a deposit-guarantee scheme which it had set up;

Whereas it is not indispensable, in this Directive, to harmonize the methods of financing schemes guaranteeing deposits or credit institutions themselves, given, on the one hand, that the cost of financing such schemes must be borne, in principle, by credit institutions themselves and, on the other hand, that the financing capacity of such schemes must be in proportion to their liabilities; whereas this must not, however, jeopardize the stability of the banking system of the Member State concerned;

Whereas this Directive may not result in the Member States' or their competent authorities' being made liable in respect of depositors if they have ensured that one or more schemes guaranteeing deposits or credit institutions themselves and ensuring the compensation or protection of depositors under the conditions prescribed in this Directive have been introduced and officially recognized;

Whereas deposit protection is an essential element in the completion of the internal market and an indispensable supplement to the system of supervision of credit institutions on account of the solidarity it creates amongst all the institutions in a given financial market in the event of the failure of any of them,

HAS ADOPTED THIS DIRECTIVE:

Article 1

For the purposes of this Directive:

1. 'deposit' shall mean any credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution must repay under the legal and contractual conditions applicable, and any debt evidenced by a certificate issued by a credit institution.

   Shares in United Kingdom and Irish building societies apart from those of a capital nature covered in Article 2 shall be treated as deposits.

   Bonds which satisfy the conditions prescribed in Article 22(4) of Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)[8] shall not be considered deposits.

   For the purpose of calculating a credit balance, Member States shall apply the rules and regulations relating to set-off and counterclaims according to the legal and contractual conditions applicable to a deposit;

2. 'joint account' shall mean an account opened in the names of two or more persons or over which two or more persons have rights that may operate against the signature of one or more of those persons;

[8] OJ No. L 375, 31.12.1985, p. 3. Directive as last amended by Directive 88/220/EEC, OJ No. L 100, 19.4.1988, p. 31.

3. 'unavailable deposit' shall mean a deposit that is due and payable but has not been paid by a credit institution under the legal and contractual conditions applicable thereto, where either:

   (i) the relevant competent authorities have determined that in their view the credit institution concerned appears to be unable for the time being, for reasons which are directly related to its financial circumstances, to repay the deposit and to have no current prospect of being able to do so.

   The competent authorities shall make that determination as soon as possible and at the latest 21 days after first becoming satisfied that a credit institution has failed to repay deposits which are due and payable; or

   (ii) a judicial authority has made a ruling for reasons which are directly related to the credit institution's financial circumstances which has the effect of suspending depositors' ability to make claims against it, should that occur before the aforementioned determination has been made;

4. 'credit institution' shall mean an undertaking the business of which is to receive deposits or other repayable funds from the public and to grant credits for its own account;

5. 'branch' shall mean a place of business which forms a legally dependent part of a credit institution and which conducts directly all or some of the operations inherent in the business of credit institutions; any number of branches set up in the same Member State by a credit institution which has its head office in another Member State shall be regarded as a single branch.

Article 2

The following shall be excluded from any repayment by guarantee schemes:

- subject to Article 8(3), deposits made by other credit institutions on their own behalf and for their own account,
- all instruments which would fall within the definition of 'own funds' in Article 2 of Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions,[9]
- deposits arising out of transactions in connection with which there has been a criminal conviction for money laundering as defined in

[9] OJ No. L 124, 5.5.1989, p. 16. Directive as last amended by Directive 92/16/EEC, OJ No. L 75, 21.3.1992, p. 48.

Article 1 of Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering.[10]

Article 3

1. Each Member State shall ensure that within its territory one or more deposit-guarantee schemes are introduced and officially recognized. Except in the circumstances envisaged in the second subparagraph and in paragraph 4, no credit institution authorized in that Member State pursuant to Article 3 of Directive 77/780/EEC may take deposits unless it is a member of such a scheme.

A Member State may, however, exempt a credit institution from the obligation to belong to a deposit-guarantee scheme where that credit institution belongs to a system which protects the credit institution itself and in particular ensures its liquidity and solvency, thus guaranteeing protection for depositors at least equivalent to that provided by a deposit-guarantee scheme, and which, in the opinion of the competent authorities, fulfils the following conditions:

- the system must be in existence and have been officially recognized when this Directive is adopted,
- the system must be designed to prevent deposits with credit institutions belonging to the system from becoming unavailable and have the resources necessary for that purpose at its disposal,
- the system must not consist of a guarantee granted to a credit institution by a Member State itself or by any of its local or regional authorities,
- the system must ensure that depositors are informed in accordance with the terms and conditions laid down in Article 9.

Those Member States which make use of this option shall inform the Commission accordingly; in particular, they shall notify the Commission of the characteristics of any such protective systems and the credit institutions covered by them and of any subsequent changes in the information supplied. The Commission shall inform the Banking Advisory Committee thereof.

2. If a credit institution does not comply with the obligations incumbent on it as a member of a deposit-guarantee scheme, the competent authorities which issued its authorization shall be notified and, in collaboration

[10] OJ No. L 166, 28.6.1991, p. 77.

with the guarantee scheme, shall take all appropriate measures including the imposition of sanctions to ensure that the credit institution complies with its obligations.

3. If those measures fail to secure compliance on the part of the credit institution, the scheme may, where national law permits the exclusion of a member, with the express consent of the competent authorities, give not less than 12 months' notice of its intention of excluding the credit institution from membership of the scheme. Deposits made before the expiry of the notice period shall continue to be fully covered by the scheme. If, on the expiry of the notice period, the credit institution has not complied with its obligations, the guarantee scheme may, again having obtained the express consent of the competent authorities, proceed to exclusion.

4. Where national law permits, and with the express consent of the competent authorities which issued its authorization, a credit institution excluded from a deposit-guarantee scheme may continue to take deposits if, before its exclusion, it has made alternative guarantee arrangements which ensure that depositors will enjoy a level and scope of protection at least equivalent to that offered by the officially recognized scheme.

5. If a credit institution the exclusion of which is proposed under paragraph 3 is unable to make alternative arrangements which comply with the conditions prescribed in paragraph 4, then the competent authorities which issued its authorization shall revoke it forthwith.

Article 4

1. Deposit-guarantee schemes introduced and officially recognized in a Member State in accordance with Article 3(1) shall cover the depositors at branches set up by credit institutions in other Member States.

Until 31 December 1999 neither the level nor the scope, including the percentage, of cover provided shall exceed the maximum level or scope of cover offered by the corresponding guarantee scheme within the territory of the host Member State.

Before that date, the Commission shall draw up a report on the basis of the experience acquired in applying the second subparagraph and shall consider the need to continue those arrangements. If appropriate, the Commission shall submit a proposal for a Directive to the European Parliament and the Council, with a view to the extension of their validity.

2. Where the level and/or scope, including the percentage, of cover offered by the host Member State guarantee scheme exceeds the level and/or scope of cover provided in the Member State in which a credit

institution is authorized, the host Member State shall ensure that there is an officially recognized deposit-guarantee scheme within its territory which a branch may join voluntarily in order to supplement the guarantee which its depositors already enjoy by virtue of its membership of its home Member State scheme.

The scheme to be joined by the branch shall cover the category of institution to which it belongs or most closely corresponds in the host Member State.

3. Member States shall ensure that objective and generally applied conditions are established for branches' membership of a host Member State's scheme in accordance with paragraph 2. Admission shall be conditional on fulfilment of the relevant obligations of membership, including in particular payment of any contributions and other charges. Member States shall follow the guiding principles set out in Annex II in implementing this paragraph.

4. If a branch granted voluntary membership under paragraph 2 does not comply with the obligations incumbent on it as a member of a deposit-guarantee scheme, the competent authorities which issued the authorization shall be notified and, in collaboration with the guarantee scheme, shall take all appropriate measures to ensure that the aforementioned obligations are complied with.

If those measures fail to secure the branch's compliance with the aforementioned obligations, after an appropriate period of notice of not less than 12 months the guarantee scheme may, with the consent of the competent authorities which issued the authorization, exclude the branch. Deposits made before the date of exclusion shall continue to be covered by the voluntary scheme until the dates on which they fall due. Depositors shall be informed of the withdrawal of the supplementary cover.

5. The Commission shall report on the operation of paragraphs 2, 3 and 4 no later than 31 December 1999 and shall, if appropriate, propose amendments thereto.

Article 5

Deposits held when the authorization of a credit institution authorized pursuant to Article 3 of Directive 77/780/EEC is withdrawn shall continue to be covered by the guarantee scheme.

Article 6

1. Member States shall check that branches established by a credit institution which has its head office outwith the Community have cover equivalent to that prescribed in this Directive.

Failing that, Member States may, subject to Article 9(1) of Directive 77/780/EEC, stipulate that branches established by a credit institution which has its head office outwith the Community must join deposit-guarantee schemes in operation within their territories.

2. Actual and intending depositors at branches established by a credit institution which has its head office outwith the Community shall be provided by the credit institution with all relevant information concerning the guarantee arrangements which cover their deposits.

3. The information referred to in paragraph 2 shall be made available in the official language or languages of the Member State in which a branch is established in the manner prescribed by national law and shall be drafted in a clear and comprehensible form.

Article 7

1. Deposit-guarantee schemes shall stipulate that the aggregate deposits of each depositor must be covered up to ECU 20 000 in the event of deposits' being unavailable.

Until 31 December 1999 Member States in which, when this Directive is adopted, deposits are not covered up to ECU 20 000 may retain the maximum amount laid down in their guarantee schemes, provided that this amount is not less than ECU 15 000.

2. Member States may provide that certain depositors or deposits shall be excluded from guarantee or shall be granted a lower level of guarantee. Those exclusions are listed in Annex I.

3. This Article shall not preclude the retention or adoption of provisions which offer a higher or more comprehensive cover for deposits. In particular, deposit-guarantee schemes may, on social considerations, cover certain kinds of deposits in full.

4. Member States may limit the guarantee provided for in paragraph 1 or that referred to in paragraph 3 to a specified percentage of deposits. The percentage guaranteed must, however, be equal to or exceed 90% of aggregate deposits until the amount to be paid under the guarantee reaches the amount referred to in paragraph 1.

5. The amount referred to in paragraph 1 shall be reviewed periodically by the Commission at least once every five years. If appropriate, the Commission shall submit to the European Parliament and to the Council a proposal for a Directive to adjust the amount referred to in paragraph 1, taking account in particular of developments in the banking sector and the economic and monetary situation in the Community. The first review

shall not take place until five years after the end of the period referred to in Article 7(1), second subparagraph.

6. Member States shall ensure that the depositor's rights to compensation may be the subject of an action by the depositor against the deposit-guarantee scheme.

Article 8

1. The limits referred to in Article 7(1), (3) and (4) shall apply to the aggregate deposits placed with the same credit institution irrespective of the number of deposits, the currency and the location within the Community.

2. The share of each depositor in a joint account shall be taken into account in calculating the limits provided for in Article 7(1), (3) and (4).

In the absence of special provisions, such an account shall be divided equally amongst the depositors.

Member States may provide that deposits in an account to which two or more persons are entitled as members of a business partnership, association or grouping of a similar nature, without legal personality, may be aggregated and treated as if made by a single depositor for the purpose of calculating the limits provided for in Article 7(1), (3) and (4).

3. Where the depositor is not absolutely entitled to the sums held in an account, the person who is absolutely entitled shall be covered by the guarantee, provided that that person has been identified or is identifiable before the date on which the competent authorities make the determination described in Article 1(3)(i) or the judicial authority makes the ruling described in Article 1(3)(ii). If there are several persons who are absolutely entitled, the share of each under the arrangements subject to which the sums are managed shall be taken into account when the limits provided for in Article 7(1), (3) and (4) are calculated.

This provision shall not apply to collective investment undertakings.

Article 9

1. Member States shall ensure that credit institutions make available to actual and intending depositors the information necessary for the identification of the deposit-guarantee scheme of which the institution and its branches are members within the Community or any alternative arrangement provided for in Article 3(1), second subparagraph, or Article 3(4). The depositors shall be informed of the provisions of the deposit-guarantee scheme or any alternative arrangement applicable, including the amount and scope of the cover offered by the guarantee

scheme. That information shall be made available in a readily comprehensible manner.

Information shall also be given on request on the conditions for compensation and the formalities which must be completed to obtain compensation.

2. The information provided for in paragraph 1 shall be made available in the manner prescribed by national law in the official language or languages of the Member State in which the branch is established.

3. Member States shall establish rules limiting the use in advertising of the information referred to in paragraph 1 in order to prevent such use from affecting the stability of the banking system or depositor confidence. In particular, Member States may restrict such advertising to a factual reference to the scheme to which a credit institution belongs.

Article 10

1. Deposit-guarantee schemes shall be in a position to pay duly verified claims by depositors in respect of unavailable deposits within three months of the date on which the competent authorities make the determination described in Article 1(3)(i) or the judicial authority makes the ruling described in Article 1(3)(ii).

2. In wholly exceptional circumstances and in special cases a guarantee scheme may apply to the competent authorities for an extension of the time limit. No such extension shall exceed three months. The competent authorities may, at the request of the guarantee scheme, grant no more than two further extensions, neither of which shall exceed three months.

3. The time limit laid down in paragraphs 1 and 2 may not be invoked by a guarantee scheme in order to deny the benefit of guarantee to any depositor who has been unable to assert his claim to payment under a guarantee in time.

4. The documents relating to the conditions to be fulfilled and the formalities to be completed to be eligible for a payment under the guarantee referred to in paragraph 1 shall be drawn up in detail in the manner prescribed by national law in the official language or languages of the Member State in which the guaranteed deposit is located.

5. Notwithstanding the time limit laid down in paragraphs 1 and 2, where a depositor or any person entitled to or interested in sums held in an account has been charged with an offence arising out of or in relation to money laundering as defined in Article 1 of Directive 91/308/EEC, the guarantee scheme may suspend any payment pending the judgment of the court.

Article 11

Without prejudice to any other rights which they may have under national law, schemes which make payments under guarantee shall have the right of subrogation to the rights of depositors in liquidation proceedings for an amount equal to their payments.

Article 12

Notwithstanding Article 3, those institutions authorized in Spain or in Greece and listed in Annex III shall be exempt from the requirement to belong to a deposit-guarantee scheme until 31 December 1999.

Such credit institutions shall expressly alert their actual and intending depositors to the fact that they are not members of any deposit-guarantee scheme.

During that time, should any such credit institution establish or have established a branch in another Member State, that Member State may require that branch to belong to a deposit-guarantee scheme set up within its territory under conditions consonant with those prescribed in Article 4(2), (3) and (4).

Article 13

In the list of authorized credit institutions which it is required to draw up pursuant to Article 3(7) of Directive 77/780/EEC the Commission shall indicate the status of each credit institution with regard to this Directive.

Article 14

1. The Member States shall bring into force the laws, regulations and administrative provisions necessary for them to comply with this Directive by 1 July 1995. They shall forthwith inform the Commission thereof.

When the Member States adopt these measures they shall contain a reference to this Directive or shall be accompanied by such reference on the occasion of their official publication. The methods of making such reference shall be laid down by the Member States.

2. The Member States shall communicate to the Commission the texts of the main provisions of national law which they adopt in the field governed by this Directive.

Article 15

This Directive shall enter into force on the day of its publication in the Official Journal of the European Communities.

Article 16

This Directive is addressed to the Member States.

Done at Brussels, 30 May 1994.

For the European Parliament	*For the Council*
The President	*The President*
E. KLEPSCH	G. ROMEOS

ANNEX I

List of exclusions referred to in Article 7(2)

1. Deposits by financial institutions as defined in Article 1(6) of Directive 89/646/EEC.
2. Deposits by insurance undertakings.
3. Deposits by government and central administrative authorities.
4. Deposits by provincial, regional, local and municipal authorities.
5. Deposits by collective investment undertakings.
6. Deposits by pension and retirement funds.
7. Deposits by a credit institution's own directors, managers, members personally liable, holders of at least 5% of the credit institution's capital, persons responsible for carrying out the statutory audits of the credit institution's accounting documents and depositors of similar status in other companies in the same group.
8. Deposits by close relatives and third parties acting on behalf of the depositors referred to in 7.
9. Deposits by other companies in the same group.
10. Non-nominative deposits.
11. Deposits for which the depositor has, on an individual basis, obtained from the same credit institution rates and financial concessions which have helped to aggravate its financial situation.
12. Debt securities issued by the same institution and liabilities arising out of own acceptances and promissory notes.
13. Deposits in currencies other than:
    - those of the Member States,
    - ecus.
14. Deposits by companies which are of such a size that they are not permitted to draw up abridged balance sheets pursuant to Article 11 of the Fourth Council Directive (78/660/EEC) of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies.[11]

---

[11]OJ No. L 222, 14.8.1978, p. 11. Directive as last amended by Directive 90/605/EEC, OJ No. L 317, 16.11.1990, p. 60.

ANNEX II

Guiding principles

Where a branch applies to join a host Member State scheme for supplementary cover, the host Member State scheme will bilaterally establish with the home Member State scheme appropriate rules and procedures for paying compensation to depositors at that branch. The following principles shall apply both to the drawing up of those procedures and in the framing of the membership conditions applicable to such a branch (as referred to in Article 4(2)):

(a) the host Member State scheme will retain full rights to impose its objective and generally applied rules on participating credit institutions; it will be able to require the provision of relevant information and have the right to verify such information with the home Member State's competent authorities;

(b) the host Member State scheme will meet claims for supplementary compensation upon a declaration from the home Member State's competent authorities that deposits are unavailable. The host Member State scheme will retain full rights to verify a depositor's entitlement according to its own standards and procedures before paying supplementary compensation;

(c) home Member State and host Member State schemes will cooperate fully with each other to ensure that depositors receive compensation promptly and in the correct amounts. In particular, they will agree on how the existence of a counterclaim which may give rise to set-off under either scheme will affect the compensation paid to the depositor by each scheme;

(d) host Member State schemes will be entitled to charge branches for supplementary cover on an appropriate basis which takes into account the guarantee funded by the home Member State scheme. To facilitate charging, the host Member State scheme will be entitled to assume that its liability will in all circumstances be limited to the excess of the guarantee it has offered over the guarantee offered by the home Member State regardless of whether the home Member State actually pays any compensation in respect of deposits held within the host Member State's territory.

ANNEX III

List of credit institutions mentioned in Article 12

(a) Specialized classes of Spanish institutions, the legal status of which is currently undergoing reform, authorized as
- Entidades de Financiación o Factoring,
- Sociedades de Arrendamiento Financiero,
- Sociedades de Crédito Hipotecario.

(b) The following Spanish state institutions:
- Banco de Crédito Agrícola, SA,
- Banco Hipotecario de España, SA,
- Banco de Crédito Local, SA.

(c) The following Greek credit cooperatives:
- Lamia Credit Cooperative,
- Ioannina Credit Cooperative,
- Xylocastron Credit Cooperative,

as well as those of the credit cooperatives of a similar nature listed below which are authorized or in the process of being authorized on the date of the adoption of this Directive:

- Chania Credit Cooperative,
- Iraklion Credit Cooperative,
- Magnissia Credit Cooperative,
- Larissa Credit Cooperative,
- Patras Credit Cooperative,
- Thessaloniki Credit Cooperative.

Appendix III

2 EC Directive on Unfair Terms in Consumer Contracts

Council Directive[1]

5 April 1993

on unfair terms in consumer contracts

(93/13/EEC)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 100A thereof,

Having regard to the proposal from the Commission,[2]

In cooperation with the European Parliament,[3]

Having regard to the opinion of the Economic and Social Committee,[4]

Whereas it is necessary to adopt measures with the aim of progressively establishing the internal market before 31 December 1992; whereas the internal market comprises an area without internal frontiers in which goods, persons, services and capital move freely;

Whereas the laws of Member States relating to the terms of contract between the seller of goods or supplier of services, on the one hand, and the consumer of them, on the other hand, show many disparities, with the result that the national markets for the sale of goods and services to consumers differ from each other and that distortions of competition may arise amongst the sellers and suppliers, notably when they sell and supply in other Member States;

Whereas, in particular, the laws of Member States relating to unfair terms in consumer contracts show marked divergences;

Whereas it is the responsibility of the Member States to ensure that contracts concluded with consumers do not contain unfair terms;

Whereas, generally speaking, consumers do not know the rules of law which, in Member States other than their own, govern contracts for the

[1] OJ No. L 95, 21.4.93, p. 29.
[2] OJ No. C 73, 24.3.1992, p. 7.
[3] OJ No. C 326, 16.12.1991, p. 108 and OJ No. C 21, 25.1.1993.
[4] OJ No. C 159, 17.6.1991, p. 34.

sale of goods or services; whereas this lack of awareness may deter them from direct transactions for the purchase of goods or services in another Member State;

Whereas, in order to facilitate the establishment of the internal market and to safeguard the citizen in his role as consumer when acquiring goods and services under contracts which are governed by the laws of Member States other than his own, it is essential to remove unfair terms from those contracts;

Whereas sellers of goods and suppliers of services will thereby be helped in their task of selling goods and supplying services, both at home and throughout the internal market; whereas competition will thus be stimulated, so contributing to increased choice for Community citizens as consumers;

Whereas the two Community programmes for a consumer protection and information policy[5] underlined the importance of safeguarding consumers in the matter of unfair terms of contract; whereas this protection ought to be provided by laws and regulations which are either harmonized at Community level or adopted directly at that level;

Whereas in accordance with the principle laid down under the heading 'Protection of the economic interests of the consumers', as stated in those programmes: 'acquirers of goods and services should be protected against the abuse of power by the seller or supplier, in particular against one-sided standard contracts and the unfair exclusion of essential rights in contracts';

Whereas more effective protection of the consumer can be achieved by adopting uniform rules of law in the matter of unfair terms; whereas those rules should apply to all contracts concluded between sellers or suppliers and consumers; whereas as a result inter alia contracts relating to employment, contracts relating to succession rights, contracts relating to rights under family law and contracts relating to the incorporation and organization of companies or partnership agreements must be excluded from this Directive;

Whereas the consumer must receive equal protection under contracts concluded by word of mouth and written contracts regardless, in the latter case, of whether the terms of the contract are contained in one or more documents;

Whereas, however, as they now stand, national laws allow only partial harmonization to be envisaged; whereas, in particular, only contractual

[5] OJ No. C 92, 25.4.1975, p. 1 and OJ No. C 133, 3.6.1981, p. 1.

terms which have not been individually negotiated are covered by this Directive; whereas Member States should have the option, with due regard for the Treaty, to afford consumers a higher level of protection through national provisions that are more stringent than those of this Directive;

Whereas the statutory or regulatory provisions of the Member States which directly or indirectly determine the terms of consumer contracts are presumed not to contain unfair terms; whereas, therefore, it does not appear to be necessary to subject the terms which reflect mandatory statutory or regulatory provisions and the principles or provisions of international conventions to which the Member States or the Community are party; whereas in that respect the wording 'mandatory statutory or regulatory provisions' in Article 1(2) also covers rules which, according to the law, shall apply between the contracting parties provided that no other arrangements have been established;

Whereas Member States must however ensure that unfair terms are not included, particularly because this Directive also applies to trades, business or professions of a public nature;

Whereas it is necessary to fix in a general way the criteria for assessing the unfair character of contract terms;

Whereas the assessment, according to the general criteria chosen, of the unfair character of terms, in particular in sale or supply activities of a public nature providing collective services which take account of solidarity among users, must be supplemented by a means of making an overall evaluation of the different interests involved; whereas this constitutes the requirement of good faith; whereas, in making an assessment of good faith, particular regard shall be had to the strength of the bargaining positions of the parties, whether the consumer had an inducement to agree to the term and whether the goods or services were sold or supplied to the special order of the consumer; whereas the requirement of good faith may be satisfied by the seller or supplier where he deals fairly and equitably with the other party whose legitimate interests he has to take into account;

Whereas, for the purposes of this Directive, the annexed list of terms can be of indicative value only and, because of the cause of the minimal character of the Directive, the scope of these terms may be the subject of amplification or more restrictive editing by the Member States in their national laws;

Whereas the nature of goods or services should have an influence on assessing the unfairness of contractual terms;

Whereas, for the purposes of this Directive, assessment of unfair character shall not be made of terms which describe the main subject matter of the contract nor the quality/price ratio of the goods or services supplied; whereas the main subject matter of the contract and the price/quality ratio may nevertheless be taken into account in assessing the fairness of other terms; whereas it follows, inter alia, that in insurance contracts, the terms which clearly define or circumscribe the insured risk and the insurer's liability shall not be subject to such assessment since these restrictions are taken into account in calculating the premium paid by the consumer;

Whereas contracts should be drafted in plain, intelligible language, the consumer should actually be given an opportunity to examine all the terms and, if in doubt, the interpretation most favourable to the consumer should prevail;

Whereas Member States should ensure that unfair terms are not used in contracts concluded with consumers by a seller or supplier and that if, nevertheless, such terms are so used, they will not bind the consumer, and the contract will continue to bind the parties upon those terms if it is capable of continuing in existence without the unfair provisions;

Whereas there is a risk that, in certain cases, the consumer may be deprived of protection under this Directive by designating the law of a non-Member country as the law applicable to the contract; whereas provisions should therefore be included in this Directive designed to avert this risk;

Whereas persons or organizations, if regarded under the law of a Member State as having a legitimate interest in the matter, must have facilities for initiating proceedings concerning terms of contract drawn up for general use in contracts concluded with consumers, and in particular unfair terms, either before a court or before an administrative authority competent to decide upon complaints or to initiate appropriate legal proceedings; whereas this possibility does not, however, entail prior verification of the general conditions obtaining in individual economic sectors;

Whereas the courts or administrative authorities of the Member States must have at their disposal adequate and effective means of preventing the continued application of unfair terms in consumer contracts,

HAS ADOPTED THIS DIRECTIVE:

Article 1

1. The purpose of this Directive is to approximate the laws, regulations and administrative provisions of the Member States relating to unfair terms in contracts concluded between a seller or supplier and a consumer.

2. The contractual terms which reflect mandatory statutory or regulatory provisions and the provisions or principles of international conventions to which the Member States or the Community are party, particularly in the transport area, shall not be subject to the provisions of this Directive.

Article 2

For the purposes of this Directive:

(a) 'unfair terms' means the contractual terms defined in Article 3;

(b) 'consumer' means any natural person who, in contracts covered by this Directive, is acting for purposes which are outside his trade, business or profession;

(c) 'seller or supplier' means any natural or legal person who, in contracts covered by this Directive, is acting for purposes relating to his trade, business or profession, whether publicly owned or privately owned.

Article 3

1. A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.

2. A term shall always be regarded as not individually negotiated where it has been drafted in advance and the consumer has therefore not been able to influence the substance of the term, particularly in the context of a pre-formulated standard contract.

The fact that certain aspects of a term or one specific term have been individually negotiated shall not exclude the application of this Article to the rest of a contract if an overall assessment of the contract indicates that it is nevertheless a pre-formulated standard contract.

Where any seller or supplier claims that a standard term has been individually negotiated, the burden of proof in this respect shall be incumbent on him.

3. The Annex shall contain an indicative and non-exhaustive list of the terms which may be regarded as unfair.

Article 4

1. Without prejudice to Article 7, the unfairness of a contractual term shall be assessed, taking into account the nature of the goods or services for which the contract was concluded and by referring, at the time of conclusion of the contract, to all the circumstances attending the conclusion

of the contract and to all the other terms of the contract or of another contract on which it is dependent.

2. Assessment of the unfair nature of the terms shall relate neither to the definition of the main subject matter of the contract nor to the adequacy of the price and remuneration, on the one hand, as against the services or goods supplies in exchange, on the other, in so far as these terms are in plain intelligible language.

Article 5

In the case of contracts where all or certain terms offered to the consumer are in writing, these terms must always be drafted in plain, intelligible language. Where there is doubt about the meaning of a term, the interpretation most favourable to the consumer shall prevail. This rule on interpretation shall not apply in the context of the procedures laid down in Article 7(2).

Article 6

1. Member States shall lay down that unfair terms used in a contract concluded with a consumer by a seller or supplier shall, as provided for under their national law, not be binding on the consumer and that the contract shall continue to bind the parties upon those terms if it is capable of continuing in existence without the unfair terms.

2. Member States shall take the necessary measures to ensure that the consumer does not lose the protection granted by this Directive by virtue of the choice of the law of a non-Member country as the law applicable to the contract if the latter has a close connection with the territory of the Member States.

Article 7

1. Member States shall ensure that, in the interests of consumers and of competitors, adequate and effective means exist to prevent the continued use of unfair terms in contracts concluded with consumers by sellers or suppliers.

2. The means referred to in paragraph 1 shall include provisions whereby persons or organizations, having a legitimate interest under national law in protecting consumers, may take action according to the national law concerned before the courts or before competent administrative bodies for a decision as to whether contractual terms drawn up for general use are unfair, so that they can apply appropriate and effective means to prevent the continued use of such terms.

3. With due regard for national laws, the legal remedies referred to in paragraph 2 may be directed separately or jointly against a number of sellers or suppliers from the same economic sector or their associations which use or recommend the use of the same general contractual terms or similar terms.

Article 8

Member States may adopt or retain the most stringent provisions compatible with the Treaty in the area covered by this Directive, to ensure a maximum degree of protection for the consumer.

Article 9

The Commission shall present a report to the European Parliament and to the Council concerning the application of this Directive five years at the latest after the date in Article 10(1).

Article 10

1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive no later than 31 December 1994. They shall forthwith inform the Commission thereof.

These provisions shall be applicable to all contracts concluded after 31 December 1994.

2. When Member States adopt these measures, they shall contain a reference to this Directive or shall be accompanied by such reference on the occasion of their official publication. The methods of making such a reference shall be laid down by the Member States.

3. Member States shall communicate the main provisions of national law which they adopt in the field covered by this Directive to the Commission.

Article 11

This Directive is addressed to the Member States.

Done at Luxembourg, 5 April 1993.

For the Council
The President
N. HELVEG PETERSEN

Annex

TERMS REFERRED TO IN ARTICLE 3(3)

1. Terms which have the object or effect of:

(a) excluding or limiting the legal liability of a seller or supplier in the event of the death of a consumer or personal injury to the latter resulting from an act or omission of that seller or supplier;

(b) inappropriately excluding or limiting the legal rights of the consumer vis-à-vis the seller or supplier or another party in the event of total or partial non-performance or inadequate performance by the seller or supplier of any of the contractual obligations, including the option of off-setting a debt owed to the seller or supplier against any claim which the consumer may have against him;

(c) making an agreement binding on the consumer whereas provision of services by the seller or supplier is subject to a condition whose realization depends on his own will alone;

(d) permitting the seller or supplier to retain sums paid by the consumer where the latter decides not to conclude or perform the contract, without providing for the consumer to receive compensation of an equivalent amount from the seller or supplier where the latter is the party cancelling the contract;

(e) requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation;

(f) authorizing the seller or supplier to dissolve the contract on a discretionary basis where the same facility is not granted to the consumer, or permitting the seller or supplier to retain the sums paid for services not yet supplied by him where it is the seller or supplier himself who dissolves the contract;

(g) enabling the seller or supplier to terminate a contract of indeterminate duration without reasonable notice except where there are serious grounds for doing so;

(h) automatically extending a contract of fixed duration where the consumer does not indicate otherwise, when the deadline fixed for the consumer to express this desire not to extend the contract is unreasonably early;

(i) irrevocably binding the consumer to terms with which he had no real opportunity of becoming acquainted before the conclusion of the contract;

(j) enabling the seller or supplier to alter the terms of the contract unilaterally without a valid reason which is specified in the contract;

(k) enabling the seller or supplier to alter unilaterally without a valid reason any characteristics of the product or service to be provided;

(l) providing for the price of goods to be determined at the time of delivery or allowing a seller of goods or supplier of services to increase their price without in both cases giving the consumer the corresponding right to cancel the contract if the final price is too high in relation to the price agreed when the contract was concluded;

(m) giving the seller or supplier the right to determine whether the goods or services supplied are in conformity with the contract, or giving him the exclusive right to interpret any term of the contract;

(n) limiting the seller's or supplier's obligation to respect commitments undertaken by his agents or making his commitments subject to compliance with a particular formality;

(o) obliging the consumer to fulfil all his obligations where the seller or supplier does not perform his;

(p) giving the seller or supplier the possibility of transferring his rights and obligations under the contract, where this may serve to reduce the guarantees for the consumer, without the latter's agreement;

(q) excluding or hindering the consumer's right to take legal action or exercise any other legal remedy, particularly by requiring the consumer to take disputes exclusively to arbitration not covered by legal provisions, unduly restricting the evidence available to him or imposing on him a burden of proof which, according to the applicable law, should lie with another party to the contract.

2. Scope of subparagraphs (g), (j) and (l)

(a) Subparagraph (g) is without hindrance to terms by which a supplier of financial services reserves the right to terminate unilaterally a contract of indeterminate duration without notice where there is a valid reason, provided that the supplier is required to inform the other contracting party or parties thereof immediately.

(b) Subparagraph (j) is without hindrance to terms under which a supplier of financial services reserves the right to alter the rate of interest payable by the consumer or due to the latter, or the amount of other charges for financial services without notice where there is a valid reason, provided that the supplier is required to inform the other contracting party or parties thereof at the earliest opportunity and that the latter are free to dissolve the contract immediately.

Subparagraph (j) is also without hindrance to terms under which a seller or supplier reserves the right to alter unilaterally the conditions of a contract of indeterminate duration, provided that he is required to inform the consumer with reasonable notice and that the consumer is free to dissolve the contract.

(c) Subparagraphs (g), (j) and (l) do not apply to:

- transactions in transferable securities, financial instruments and other products or services where the price is linked to fluctuations in a stock exchange quotation or index or a financial market rate that the seller or supplier does not control;
- contracts for the purchase or sale of foreign currency, traveller's cheques or international money orders denominated in foreign currency;

(d) Subparagraph (l) is without hindrance to price-indexation clauses, where lawful, provided that the method by which prices vary is explicitly described.

Notes

Introduction (Effros)

1. Baron de Montesquieu, *The Spirit of the Laws* 157 (Anne M. Cohler *et al.* eds. and trans., 1989).

2. *The Federalist No. 47,* at 302 (James Madison) (Clinton Rossiter ed., 1961).

3. *Id.* at 302–03.

4. *Myers v. United States,* 272 U.S. 52, 291 (1926) (Brandeis, J., dissenting).

5. John Locke, *Two Treatises of Government* 362–63 (Peter Laslett ed., student ed. 1988).

6. J.F. Garner, *Administrative Law* 49 (6th ed. 1985).

7. *See* John H. Reese, *Administrative Law Principles and Practice* 74 (1995). *Cf.* J.F. Garner, *Administrative Law* 122 (5th ed. 1979).

8. *See* Reese, *supra* note 7, at 74.

9. 12 United States Code [U.S.C.] § 325 (1994).

10. *Id.* § 1844(c).

11. *Id.* §§ 248(i), 1844(b).

12. 5 U.S.C. §§ 554–59 (1994).

13. 12 U.S.C. § 1818(b) (1994).

14. *Id.* § 1818(e).

15. *Id.* § 1818(i)(2).

16. Martin S. Flaherty, *The Most Dangerous Branch*, 105 Yale Law Journal 1725, 1827 (1996).

17. The Swedish central bank law provides:

> After the end of each year the Board of Directors of the Riksbank shall submit to the Banking Committee of the Riksdag a report on the position, business, and administration of the Riksbank. This report shall be printed and made public.

The Sveriges Riksbank Act 1934, Chapter 6, Art. 37 (as amended June, 1949).

18. 12 U.S.C. § 225a (1994).

19. *See* The Centre for Economic Policy Research, *Independent and Accountable—A New Mandate for the Bank of England* 4.3 (1993) (report of an independent panel chaired by Eric Roll).

20. 12 U.S.C. § 241 (1994).

21. This criterion is modeled after Article 14.2 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank to the Maastricht Treaty. The Protocol is *reprinted in* 3 *Current Legal Issues Affecting Central Banks* 359 (Robert C. Effros ed., 1995).

22. 12 U.S.C. § 242 (1994).

23. Bank of England Act, 1946, 9 & 10 Geo. 6, Chapter 26, § 4(1).

24. Crown Proceedings Act, 1947, 10 & 11 Geo. 6, Chapter 44, §§ 1–2.

25. L. Neville Brown & John S. Bell, *French Administrative Law* 176 (4th ed. 1993).

26. *Id.* at 174. The general liability that Blanco attributed to the state applies as well to all public authorities. *See id.* at 176 (discussing *Feutry,* Tribunal des Conflits 29 February 1908).

27. Central Bank Act, Chapter 79:02, § 44(H) (1980).

28. Banking Act 1987, Chapter 22, § 1(4).

29. 28 U.S.C. § 1346(b) (1994).

30. *See Horne v. Federal Reserve Bank of Minneapolis,* 344 F.2d 725 (8th Cir. 1965) and *Raichle v. Federal Reserve Bank of New York*, 34 F.2d 910 (2d Cir. 1929) discussed at the

text cited in notes 63–66. However, for a decision sustaining a bill in equity brought against a Federal Bank and its officers when they were exceeding their statutory authority, *see* the opinion of Justice Holmes in ***American Bank & Trust Company v. Federal Reserve Bank***, 256 U.S. 350 (1921). Here the Bank was charged with accumulating checks of country banks and presenting them in large quantities to compel them to become members of the Federal Reserve System. The Supreme Court of the United States stated in the course of its opinion that "the United States did not intend by that statute [the Federal Reserve Act] to sanction this sort of warfare. . . ." *Id.* at 359.

31. 28 U.S.C. § 2680(a) (1994).

32. *United States v. Gaubert*, 499 U.S. 315 (1991).

33. The Conseil d'Etat has other functions as well. All bills submitted to Parliament by the Government must be first submitted to the Conseil for its advice. Aside from the legislative process, the Conseil d'Etat acts as general legal adviser to individual ministers. The Conseil d'Etat submits an annual report to the President of the Republic, reviewing its work and proposing reforms of an administrative or legislative nature. *See* Brown & Bell, *supra* note 25, at 61–63.

34. *See id.* at 252.

35. *See generally* Garner, *supra* note 6, at 122–218.

36. *Associated Provincial Picture Houses Ltd. v. Wednesbury Corp.*, [1948] 1 King's Bench 223 (Eng. C.A. 1947).

37. Zaim M. Nedjatigil, *Judicial Control of Administrative Discretion: A Comparative Study*, 14 Anglo–American Law Review 97, 101 (1985).

38. Banking Act 1987, Chapter 22, § 1(4).

39. *Id.* §§ 27–31.

40. [1988] 1 Appeal Cases 175 (P.C. 1987), [1987] 2 All England Law Reports [All E.R.] 705 (1987).

41. [1990] 2 All E. R. 536 (1990), [1990] 1 Weekly Law Reports 821 (1990).

42. *But see States of Guernsey v. Firth* (unreported), 14 May 1981, Court of Appeal of Guernsey (Civil Division) (Appeal No. 10 Civil) which is distinguished in the *Yuen* case at [1988] 1 App. Cas. 175, 197 (P.C. 1987).

43. *See Three Rivers District Council and Others v. Bank of England*, [1996] 3 All E.R. 558 (Queen's Bench Division (Commercial Court)).

44. Brown & Bell, *supra* note 25, at 223.

45. Garner, *supra* note 6, at 166.

46. Brown & Bell, *supra* note 25, at 245–50.

47. In questions of law, a U.S. court may decide whether an administrative agency has exceeded its statutory authority. Thus, if the law that the agency is charged to interpret requires that it take into account certain factors or interests, the court may find that the agency failed to take such into account in coming to its decision or that it wrongly substituted other factors that were not relevant or countenanced by the statutory delegation. A court may also decide that the enabling statute is unambiguous so that it does not admit the interpretation adopted by the agency or that such interpretation is unreasonable. When the court reviews the fact-finding of an agency, ordinarily it may defer to the special expertise of the agency. Accordingly, its test should be whether the agency's fact-finding was reasonable: Is there substantial evidence upon which a reasonable fact finder may come to such a conclusion? Such an approach limits the court's review because it should not ordinarily seek to substitute its own fact-finding *de novo* for that of the agency. When a court reviews the agency's exercise of discretion, the standard for its review may be described as determining whether the agency's action was arbitrary, capricious, or otherwise constituting an abuse of discretion. Other examples may be (i) when the agency's decision is inconsistent with its own rules, which must be accorded the force of law until changed; (ii) when the agency's decision departs from its prior adjudicative decisions, if the reasons for the depar-

ture are not satisfactorily explained; (iii) when the agency's decision constitutes a departure from certain principles inherent in the applicable jurisprudence (such as estoppel or *res judicata*); or (iv) if a retroactive decision penalizes conduct that reasonably was believed to be lawful. Similar standards may be employed by a review court when it is called on to judicially review rules that an administrative agency issues in exercising its legislative functions. *See generally* Ernest Gellhorn & Ronald M. Levin, *Administrative Law and Process* 75–117 (1990).

48. Public Law No. 79–404, Chapter 324 (1946) (codified as amended at 5 U.S.C. §§ 551–59, 701–706, 1305, 3105, 5372, and 7521 (1994 & Supp. I 1995)).

49. *See generally* Gellhorn & Levin, *supra* note 47, at 75–117.

50. 5 U.S.C. § 706(2)(B) (1994).

51. *Id.* § 706(2)(C).

52. *Id.* § 706(2)(E).

53. *Id.* § 706(2)(F).

54. *Id.* § 706(2)(A).

55. *Id.* § 706(2)(D).

56. *Id.* § 702.

57. Relief for damages against the United States on breach of contract or a taking of property without just compensation can be sought. 28 U.S.C. § 1491 (1994).

58. *Id.* §§ 1346, 2671–80.

59. *Id.* § 2680(a). *See United States v. S.A. Empresa de Viacao Area Rio Grandense (Varig Airlines)*, 467 U.S. 797 (1984); *Berkovitz v. United States*, 486 U.S. 531 (1988).

60. *United States v. Gaubert*, 499 U.S. 315 (1991).

61. The pertinent language concerning the FDIC appears in 12 U.S.C. § 1819 Fourth (1994).

62. *See Federal Deposit Insurance Corp. v. Citizens Bank & Trust Co.*, 592 F.2d 364 (7th Cir. 1979).

63. 344 F.2d 725 (8th Cir. 1965).

64. *Id.* at 728.

65. 34 F.2d 910 (2d Cir. 1929).

66. *Id.* at 915.

67. 235 F. Supp. 877 (D. Mont. 1964).

68. *See* Bernard Schwartz, *French Administrative Law and the Common-Law World* 179 (1954).

69. *Id.* (quoting Waline, *Traité élémentaire de droit administratif* 116 (6th ed. 1951)).

70. *See Gold v. Ernst & Ernst (In re Franklin National Bank Securities Litigation)*, 445 F. Supp. 723 (E.D.N.Y. 1978); *see also First Federal Savings & Loan v. First Federal Savings & Loan*, 446 F. Supp. 210 (N.D. Ala. 1979).

71. *First State Bank v. United States*, 599 F.2d 558 (3d Cir. 1979); *Emch v. United States*, 630 F.2d 523 (7th Cir. 1980).

72. *Harmsen v. Smith*, 586 F.2d 156 (9th Cir. 1978).

73. *Davis v. Federal Deposit Insurance Corp.*, 369 F. Supp. 277 (D. Colo. 1974).

74. Federal Court of Justice, Ruling of February 15 and July 12, 1979, Wertpapier-Milleilungen 1979 [Securities Information 1979], *cited in* Berthold Wahlig, *A German Perspective* (Chapter 18B).

75. Banking Act, Division 2 § 6(3) (as amended July 1985).

76. *Id.* A related issue concerns whether in the exercise of its powers as conservator or receiver of a failed bank, an injunction can be brought against the banking supervisory authority to stay it from taking action. In a recent U.S. case, *James Madison Ltd., By Hecht v. Ludwig*, 82 F.3d 1085 (D.C. Cir. 1996), the Court of Appeals for D.C. took note of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. This provision states: "Except as provided in this section no court may take any action, except at the request

of the Board of Directors [of the FDIC] to restrain or affect the exercise of powers or functions of the [FDIC] as a conservator or a receiver." 12 U.S.C. § 1821(j) (1994). The court concluded that the provision operates "to prevent courts from interfering with the FDIC only when the agency acts within the scope of its authorized powers, not when the agency was improperly appointed in the first place." *Hecht*, 82 F.3d at 1093. However, the court rejected an argument that considerations of due process require a hearing by the government prior to disposition of the failed bank's assets. *Id.* at 1099. The court noted that

> the Government has a substantial interest in moving quickly to seize insolvent institutions. We have previously recognized that requiring a pre-seizure hearing could expose both depositors and the FDIC insurance fund to further losses from the continued operation of a failed institution by its management. *Haralson v. Federal Home Loan Bank Bd.*, 837 F.2d 1123, 1127 (D.C.Cir. 1988). Equally strong is the Government's interest in swiftly disposing of assets and liabilities after a seizure takes place in order to ensure the smooth transfer of a bank's deposits and branches to other institutions, as well as to minimize losses for both depositors and taxpayers that could occur if the Government had to hold on to a bank's assets when the value of those assets is declining.

Hecht, 82 F.3d at 1100.

77. 12 Code of Federal Regulations § 261.8 (1996).

78. *Id.* § 261.7.

79. *Id.* § 281.2.

80. *Id.* § 261b.5.

81. In addition, there is an audit by the General Accounting Office. Board of Governors of the Federal Reserve System, *The Federal Reserve System: Purposes & Functions* 7 (1994).

82. Bank of England, *Report & Accounts 1996* at 44 (1996).

83. *Id.*

84. *Id.* at 47.

85. Elizabeth Hennessy, *A Domestic History of the Bank of England, 1930–1960* at 193–94 (1992).

86. *Report & Accounts 1996, supra* note 82, at 15. Prior to September 1993, the draft of this report was reviewed by the Treasury. Since that time, the report has been published unseen by the Treasury; however, the report cannot contain any views or projections that the Bank has not already addressed with the Treasury in private. Rupert Pennant-Rea, *The Bank Yesterday, Today, Tomorrow*, in *The Bank of England 1930–1960* at 221 (1992).

87. *Report & Accounts 1996, supra* note 82, at 15.

88. Christos Hadjiemmanuil, *Banking Regulation and the Bank of England* 407 (1996).

89. Pennant-Rea, *supra* note 86, at 222.

90. *An Old Lady with Attitude*, The Economist, U.K. edition, July 30, 1994, at 52.

91. The principle has been described in *Eight Little Piggies: Reflections in Natural History*:

> Ichthyosaurs are a group of marine reptiles with bodies so fishlike in external form that they have become the standard textbook example of "convergence"—evolved similarity from two very different starting points as independent adaptive responses to a common environment and mode of life (wings of birds and bats, eyes of squids and fishes).

Stephen J. Gould, *Eight Little Piggies: Reflections in Natural History* 81 (1993).

92. *See generally* Rosa Lastra, *Central Banking and Banking Regulation* 49–59 (1996) discussing the accountability of central banks).

93. *First Report from the Select Committee on Nationalised Industries, "Bank of England"* Session 1969–70, Part IV, paragraph 269 (British House of Commons Report).

94. *Id.* paragraph 258.

Chapter 1A, "Some Specific Legal Features of the International Monetary Fund" (Gianviti)

1. The ESAF Trust also holds resources transferred from the Special Disbursement Account.

2. International Monetary Fund, Articles of Agreement, Art. I(v) (April 1993).

3. International Monetary Fund, Articles of Agreement, Art. V, § 3(*a*)(i) (July 22, 1944)(providing "[t]he member desiring to purchase the currency represents that it is presently needed for making in that currency payments which are consistent with the provisions of this Agreement . . ."), *reprinted in* III *The International Monetary Fund 1945–1965* at 185, 191 (J. Keith Horsefield ed., 1969).

4. *Id.* Art. VI, § 1.

5. Articles of Agreement, *supra* note 2, Art. I(ii).

6. *Id.* Art. VIII, § 2(*a*).

7. *Id.* Art. VI, § 3.

8. *Id.* Art. I(v).

9. From the member's perspective, crediting the Fund's account with its currency requires either available budgetary resources or a loan (for example, from the central bank), while a promissory note is costless. Moreover, once foreign exchange is received from the Fund, it can be converted into local currency, which, if received in exchange for a promissory note, will increase the local currency resources available to the member. From the Fund's perspective, there may be a need to receive currency rather than a promissory note, if that currency is needed for its operations and transactions. In that case, the Fund may require the member to convert all or part of the promissory note into an equivalent amount of the member's currency. *Id.* Art. III, § 4.

10. *Id.* Art. V, § 11.

11. As in all purchases of the Fund's resources, the member must represent that it has a need to make the purchase, but, in this case, the Fund cannot challenge the request *Id.* Art. V, § 3(*c*). Moreover, reserve tranche purchases can be made even to finance a large or sustained outflow of capital. *Id.* Art. VI, § 2.

12. A member declared ineligible to use the Fund's general resources cannot make a reserve tranche purchase or any other purchase.

13. Decision No. 287-3 (March 17, 1948), *reprinted in Selected Decisions and Selected Documents of the International Monetary Fund* 63 (20th issue, 1995).

14. Articles of Agreement, *supra* note 2, Art. XXX(*b*).

15. Article V, § 3(*c*) provides:

> The Fund shall examine a request for a purchase to determine whether the proposed purchase would be consistent with the provisions of this Agreement and the policies adopted under them, provided that requests for reserve tranche purchases shall not be subject to challenge.

16. Decision No. 10348-(93/61) STF (April 23, 1993, as amended), *reprinted in Selected Decisions*, *supra* note 13, at 186.

17. Vienna Convention on Succession of States in Respect of Treaties, August 22, 1978, U.N. Doc. A/Conf. 80/31 (1978), U.N. Doc. A/Conf. 80/31/Corr.2 (1978), *reprinted in* 17 International Legal Materials [I.L.M.] 1488 (1978); Vienna Convention on Succession of States in Respect of State Property, Archives and Debts, April 7, 1983, U.N. Doc. A/Conf. 117/14 (1983), *reprinted in* 22 I.L.M. 306 (1983).

18. The two republics were united in a federation, the Federal Republic of Yugoslavia, which claimed to continue the existence of the Socialist Federal Republic of Yugoslavia.

19. The terms "Republic of Macedonia" and "Macedonia" were used informally before the Fund decided to adopt, as a provisional designation, the terms "former Yugoslav Republic of Macedonia" until a name could be agreed upon between that country and the Fund.

20. *See* U.N. Security Council Resolution 777, 3116th Meeting, September 19, 1992; U.N. General Assembly Resolution 47/1, 7th plenary meeting, September 22, 1992.

21. Arbitration Committee of the Conference on Yugoslavia, *Opinion No. 1* (Delivered November 29, 1991), ***reprinted as an annex to*** Alain Pellet, ***The Opinions of the Badinter Arbitration Committee: A Second Breath for the Self-Determination of Peoples***, 3 European Journal of International Law 178, 182 (1992).

22. Another reason could have been a disagreement on the proposed allocation of the quota, assets, and liabilities of the Socialist Federal Republic of Yugoslavia, but in fact this issue did not arise.

23. The imposition of sanctions by the UN Security Council was not legally an obstacle to the membership of the Federal Republic of Yugoslavia (Serbia and Montenegro) in the Fund.

24. Similarly, the allocation of Czechoslovakia's quota, assets, and liabilities in the Fund was acceptable to the two successor states.

Chapter 1B, "The Relationship Between the International Monetary Fund and the United Nations" (Holder)

1. U.N. Charter Art. 1.

2. International Monetary Fund, Articles of Agreement, Art. IX, § 2 (April 1993); U.N. Charter Art. 104.

3. Articles of Agreement, ***supra*** note 2, Art. X.

4. U.N. Charter Art. 57(1).

5. Agreement Between the United Nations and the International Monetary Fund, November 15, 1947, Art. I, paragraph 2 [hereinafter Relationship Agreement], ***reprinted in Selected Decisions and Selected Documents of the International Monetary Fund*** 543 (20th issue, 1995).

6. Committee on Negotiations with Specialized Agencies, ***Report on Negotiations with the International Bank for Reconstruction and Development and the International Monetary Fund***, U.N. Economic and Social Council Doc. E/564, at 3 (August 16, 1947).

7. Relationship Agreement, ***supra*** note 5.

8. Agreement Between the United Nations and the International Bank for Reconstruction and Development, November 15, 1947, Art. IV, paragraph 3, ***reprinted in Agreements Between the United Nations and the Specialized Agencies and the International Atomic Energy Agency*** at 53, U.N. Doc. ST/SG/14, U.N. Sales No. 61.X.1 (1961). The International Finance Corporation and the International Development Association entered into agreements on the same terms as those of the IBRD, in 1957 and 1961, respectively. Agreement Between the United Nations and the International Bank for Reconstruction and Development (Acting for and on Behalf of the International Finance Corporation) on the Relationship Between the United Nations and the International Finance Corporation, February 20, 1957, ***reprinted in Agreements Between the United Nations and the Specialized Agencies, supra***, at 88; Agreement Between the United Nations and the International Development Association, March 27, 1961, ***reprinted in Agreements Between the United Nations and the Specialized Agencies, supra***, at 111.

9. ***Report on Negotiations with the International Bank for Reconstruction and Development and the International Monetary Fund***, ***supra*** note 6, at 3. Under the World Bank's Articles of Agreement, its involvement in "political" activity is prohibited. International Bank for Reconstruction and Development, Articles of Agreement, Art. IV, § 10 (1989). Loans are to be used for the purposes for which they were granted, and "without regard to political or other non-economic influences or considerations." ***Id.*** Art. III, § 5(b).

10. General Assembly Resolution 172 (Part D), U.N. GAOR, 36th Session, 102d plenary meeting, at 41–42 (1981).

11. General Assembly Resolution 2, U.N. GAOR, 37th Session, 40th plenary meeting, at 14 (1982).

12. International Monetary Fund, Press Release No. 82/52 (November 3, 1982).

13. Article 48 of the U.N. Charter provides:

> 1. The action required to carry out the decisions of the Security Council for the maintenance of international peace and security shall be taken by all the Members of the United Nations or by some of them, as the Security Council may determine.
> 2. Such decisions shall be carried out by the Members of the United Nations directly and through their action in the appropriate international agencies of which they are members.

U.N. Charter Art. 48.

14. Under that proposal, the Fund would have recognized

> . . . the obligations which are imposed upon members of the United Nations by Article 48 of the Charter to carry out decisions of the Security Council for the maintenance of international peace and security, both directly and through their actions in the related appropriate agencies of which they are members.

Legal Department, International Monetary Fund, ***Agreement with the United Nations—Report of the General Counsel on Negotiations with the Committee on Negotiations with Specialized Agencies of the Economic and Social Council***, Executive Board Document No. 191, Revision 1, Supplement 3, at 4 (August 20, 1947).

15. By way of example, the International Labor Organization agreement states:

> The International Labour Organisation agrees to transmit its proposed budget to the United Nations annually at the same time as such budget is transmitted to its members. The General Assembly shall examine the budget or proposed budget of the Organisation and may make recommendations to it concerning any item or items contained therein.

Agreement Between the United Nations and the International Labour Organisation, December 14, 1946, Art. XIV, paragraph 4, ***reprinted in Agreements Between the United Nations and the Specialized Agencies, supra*** note 8, at 1.

16. Relationship Agreement, ***supra*** note 5, Art. X, paragraph 3, first sentence.

17. ***Id.*** Art. II. The clause on attendance at Executive Board meetings was narrowed during negotiation: the UN draft provided for attendance at all Board meetings.

18. ***Id.*** Art. IV.

19. ***Id.*** Art. I, paragraph 3.

20. ***Id.*** Art. XIII, paragraph 1.

21. ***Id.*** Art. XIII, paragraph 2.

22. ***Id.*** Art. XIII, paragraph 3.

23. General Assembly Resolution 264, U.N. GAOR, 45th Session, Supp. No. 49 A, at 2, 3 (Annex paragraph 4(a)), U.N. Doc. A/45/49/Add.1 (1992).

24. Supplementary report prepared by Mr. Francis Blanchard on the functioning of the ACC, ACC/1993/CRP.1, March 29, 1993.

25. ***Id.*** at 3–4.

Chapter 2, "Developments at the International Bank for Reconstruction and Development: The Restructuring of the Global Environment Facility" (Rigo)

1. ***See*** Mohamed El-Ashry, ***The New Global Environment Facility,*** Finance & Development 48 (June 1994).

2. ***See id.***; Agenda–21, U.N. Doc. A/CONF. 151/26 (Vol. 1), August 12, 1992.

3. ***See*** Declaration of the United Nations Conference on the Human Environment, U.N. Doc. A/CONF. 48/14, June 16, 1972, ***reprinted in International Organization and Integration*** I.A.14.1.a (P.J.G. Kapteyn ***et al.*** eds., 1981).

4. World Commission on Environment and Development, ***Our Common Future*** (1987); World Resources Institute, ***Natural Endowments: Financing Resource Conservation for Development*** (1989).

5. *Report of the Independent Evaluation of the Global Environment Facility, Pilot Phase,* at vi (1993).

6. Procedural Arrangements Among the International Bank for Reconstruction and Development (World Bank), the United Nations Enviroment Program (UNEP), and the United Nations Development Program (UNDP) for Operational Cooperation Under the Global Enviroment Facility (October 28, 1991).

7. *Id.* paragraph 1.

8. Ibrahim F.I. Shihata, *The World Bank and the Environment: A Legal Perspective, in The World Bank in a Changing World* 135 (Franziska Tschofen & Antonio R. Parra eds., 1991).

9. Montreal Protocol on Substances that Deplete the Ozone Layer, adopted at Montreal, Canada, September 16, 1987, as amended [hereinafter Montreal Protocol], *reprinted in* Inter-American Development Bank, *International Environmental Law* 52 (1993).

10. *Id.*

11. Vienna Convention for the Protection of the Ozone Layer, adopted in Vienna, March 22, 1985, *reprinted in International Environmental Law, supra* note 9, at 30.

12. Agreement Between the Executive Committee of the Interim Multilateral Fund for the Implementation of the Montreal Protocol and the International Bank for Reconstruction and Development (World Bank) (June 19, 1991); Adjustment and Amendment to the Montreal Protocol on Substances that Deplete the Ozone Layer, done in London, June 29, 1990, paragraph T, *reprinted in International Environmental Law, supra* note 9, at 68 (providing for the creation of the Multilateral Fund).

13. GEF Administrator's Office, *The Global Environment Facility: Beyond The Pilot Phase* 3 (April 24, 1992).

14. Agenda-21, *supra* note 2; United Nations Framework Convention on Climate Change, adopted in Rio de Janerio, Brazil, June 4, 1992, *reprinted in International Environmental Law, supra* note 9, at 159; United Nations Convention on Biological Diversity, done at Rio de Janerio, Brazil, June 5, 1992, *reprinted in International Environmental Law, supra,* at 189.

15. International Bank for Reconstruction and Development, *Instrument for the Establishment of the Restructured Global Environment Facility* (March 1994) [hereinafter *RGEF Instrument*].

16. *Id.* paragraphs 11–24.

17. *Id.* paragraph 25.

18. *See* Edith Brown Weiss, *International Environmental Law: Contemporary Issues and the Emergence of a New World Order,* 81 Georgetown Law Journal 675, 703 (1993); A. Dan Tarlock, *Environmental Protection: The Potential Misfit Between Equity and Efficiency,* 63 University of Colorado Law Review 871 (1992) (discussing the issue of efficiency versus equity).

19. *See supra* notes 9 and 15.

20. *RGEF Instrument, supra* note 15, introduction; IBRD, Executive Directors' Resolution No. 94-2, *Global Environment Facility Trust Fund: Restructuring and First Replenishment of the Global Environment Facility* (adopted May 24, 1994) *in RGEF Instrument, supra,* at 37; IBRD Board of Governors, Resolution No. 487, *Protection of the Global Environment* (adopted July 7, 1994) *in RGEF Instrument, supra,* at 38; Governing Council of the United Nations Environment Program, *Adoption of the Instrument for the Establishment of the Restructured Global Environment Facility,* SS.IV.1 (adopted June 18, 1994) *in RGEF Instrument, supra,* at 36; Executive Board of the United Nations Development Program and of the United Nations Population Fund, *Report on the Second Regular Session,* DP/1994/9, Part VIII.A (adopted May 13, 1994) *in RGEF Instrument, supra,* at 35.

Chapter 3, "Developments at the International Finance Corporation" (Sullivan)

1. International Finance Corporation, ***Annual Report 1994***, at 1.
2. *Id.* at 5; IFC, ***Annual Report 1993*** at 1, 17.
3. IFC, ***Annual Report 1993*** at 62–63, 66.
4. *Id.* at 63.
5. *Id.* at 47.

Chapters 2 and 3, Comment (Berenson)

1. International Bank for Reconstruction and Development, ***Instrument for the Establishment of the Restructured Global Environment Facility***, paragraph 21 (March 1994).
2. *Id.* paragraphs 13, 14.
3. *Id.* paragraphs 15–17.
4. *Id.* paragraph 25.

Chapter 4, "The First Three Years of the European Bank for Reconstruction and Development: Legal Issues and Solutions" (Newburg)

1. Sir Joseph Gold, ***The Rule of Law in the International Monetary Fund***, IMF Pamphlet Series No. 32, at 1 (1980).
2. *Id.*
3. The Agreement Establishing the European Bank for Reconstruction and Development [hereinafter Agreement] was signed in Paris on May 29, 1990 by 40 countries, the European Community, and the European Investment Bank, which subscribed to substantially all of the Bank's capital stock of ECU 10 billion. The Agreement is reprinted in Appendix I of Ibrahim F.I. Shihata, ***The European Bank for Reconstruction and Development: A Comparative Analysis of the Constituent Agreement*** (1990).
4. Asian Development Bank, Articles of Agreement, ***in Basic Documents of the Asian Development Bank*** (1971); International Bank for Reconstruction and Development (IBRD), Articles of Agreement (1989).

Indeed, the Agreement has been criticized for repeating certain clauses that have fallen into disuse or proven unduly cumbersome in practice. ***The European Bank for Reconstruction and Development, supra*** note 3, at 5–6. Mr. Shihata believes that more use could have been made of more recent agreements, such as the amended articles of the IMF and the Agreement Establishing the Multilateral Investment Guarantee Agency. He also criticizes the use of the charter of the Asian Development Bank (ADB) as a model for the provisions relating to private sector development, as opposed to the Articles of Agreement of the International Finance Corporation (IFC), which he finds more relevant.

5. It has been argued that the practices of other international financial institutions should not serve as an aid to the interpretation of the EBRD's Agreement for a number of reasons: the EBRD's overt political purpose; the existence of explanatory notes in the Chairman's Report, ***see infra*** note 10; the lack of judicial decisions relating to international financial institutions; the fact that the Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331, does not recognize administrative practices of international organizations as aids to the interpretation of treaties; the EBRD's merchant bank character; and the urgency of the EBRD's tasks (which may lend a "special momentum to the evolution of the Bank and may impart a progressive meaning to the text of the Bank's constituent document"). ***See*** D.R.R. Dunnett, ***The European Bank for Reconstruction and Development: A Legal Survey***, 28 Common Market Law Review 571, 574 (1991).
6. Agreement, ***supra*** note 3, Art. 1.
7. *Id.* Art. 8.2.
8. *Id.* Art. 2.1(vii).
9. *Id.* Art. 2.1.

10. *See* Chairman's Report on the Agreement Establishing the European Bank for Reconstruction and Development, note 1 to Art. 2, ***reprinted in The European Bank for Reconstruction and Development, supra*** note 3, Appendix V [hereinafter Chairman's Report] (stating that the focus of the Bank is to be the private sector but that the Bank should also "support the public sector in its transition").

11. *See* IBRD, Articles of Agreement, ***supra*** note 4, Art. IV, § 10; ***see also*** ADB, Articles of Agreement, ***supra*** note 4, Art. 36.2. Both prohibit political activity and state that "[o]nly economic considerations shall be relevant to decisions."

12. *See, e.g.*, Ibrahim F.I. Shihata, ***The World Bank and Human Rights, in The World Bank in a Changing World*** 97 (Franziska Tschofen & Antonio Parra eds., 1991) (distinguishing the World Bank's human rights and environmental activities from political interference in the affairs of its members).

13. Opening statement by Jacques de Larosière, President of the EBRD, Proceedings of the Third Annual Meeting of the Board of Governors, St. Petersburg, April 18–19, 1994 [hereinafter Proceedings of the Third Annual Meeting].

14. Procedures to Implement the Political Aspects of the Mandate of the European Bank for Reconstruction and Development, BDS91–16 (May 28, 1991). The procedures of this policy paper are developed further in a policy paper on Political Aspects of the Mandate of the European Bank in Relation to Ethnic Minorities, BDS92–103 (October 5, 1992) and in a staff paper on War and Democracy, SGS92–714 (January 4, 1993).

15. Convention for the Protection of Human Rights and Fundamental Freedoms, November 4, 1950, 213 United Nations Treaty Series [U.N.T.S.] 221, ***reprinted in*** 3 ***International Law & World Order*** II.B.2 (Burns H. Weston ed., 1994); Statute of the Council of Europe, May 5, 1949, 87 U.N.T.S. 103, ***reprinted in*** II ***International Organization and Integration*** II.B.3.a (P.J.G. Kapteyn *et al.* eds., 1983).

16. Agreement, ***supra*** note 3, Art. 8.3.

17. *Id.* Art. 20.1(vi) (stating that the Bank may provide technical advice and assistance which serve its purpose and come within its functions).

18. *Id.* Art. 2.1.(vii).

19. *See* Environmental Procedures, BDS91–71 (February 14, 1992); Environmental Management: The Bank's Policy Approach, BDS91–72 (February 14, 1992) [hereinafter Environmental Policy]; ***see also*** Chris A. Wold & Durwood Zaelke, ***Promoting Sustainable Development and Democracy in Central and Eastern Europe: The Role of the European Bank for Reconstruction and Development***, 7 American University Journal of International Law & Policy 559 (1992); Kamen Zahariev, ***European Bank for Reconstruction and Development: Environmental Aspects of Operations,*** 2 Recueil 31 (1993) (providing an overview of the environmental procedures).

20. Environmental Policy, ***supra*** note 19, at 2.

21. EBRD, ***1993 Annual Report*** 29 (1994).

22. Proceedings of the Third Annual Meeting, ***supra*** note 13.

23. Agreement, ***supra*** note 3, Arts. 3.2, 24.2(i).

24. It appears that the German Democratic Republic parliament, immediately before going out of existence, ratified the Agreement, but that the instrument of ratification was never received by the French Government, the depository under the Agreement. *See* Jacques Attali, ***Europe(s)*** 90 (1994).

25. *See* Paul A. Menkveld, ***Origin and Role of the European Bank for Reconstruction and Development*** 60 (1991); ***see also*** Dunnett, ***supra*** note 5, at 577.

26. The Bank's authorized capital stock of ECU 10 billion is divided into one million shares having a par value of ECU 10,000 each. At the time of signature of the Agreement, 125 shares were not subscribed and designated as nonallocated. Agreement, ***supra*** note 3, Annex A.

27. Albania became a member on December 18, 1991, Estonia on February 28, 1992, Lithuania on March 5, 1992, and Latvia on March 18, 1992. Having regard to the shareholding and voting power of existing recipient countries, the Board of Governors allocated 1,000 shares to each of these new members.

28. *See* Agreement, ***supra*** note 3, Art. 3 (stating that membership is open "to (1) European countries and (2) non-European countries which are members of the International Monetary Fund . . ."); ***see also id.*** Art. 8 (captioned "Recipient Countries and Use of Resources" and providing that the Bank may conduct its operations in Central and Eastern European countries). The eight original recipient countries are listed under the heading "Recipient Countries" in Annex A to the Agreement, which sets out the subscriptions to the capital stock. ***Id.*** Annex A. A footnote to Annex A states that "Recipient Countries are referred to elsewhere in the Agreement as Central and Eastern European countries." ***Id.***

29. Membership Issues Following the Dissolution of the USSR, BDS92-2 (January 28, 1992) [hereinafter Membership Issues].

30. ***Id.*** at 1.

31. ***Id.***

32. ***Id.*** at 4.

33. *See* Attali, ***supra*** note 24, at 65–67 (describing the circumstances of the negotiations).

34. Agreement, ***supra*** note 3, Art. 8.4.

35. ***Id.*** The "limited purposes" consist of technical assistance and of financing of the private sector, to facilitate privatization and to help state-owned enterprises move to participation in the market economy. They do not include the financing of infrastructure, one of the methods of operation of the Bank used to the extent "necessary for private sector development and the transition to a market-oriented economy." ***Id.*** Art. 11.1(v). In view of the quantitative limitation, significant infrastructure financing would not in any event seem practicable.

36. Letter to the Chairman of the Conference on the Establishment of the European Bank for Reconstruction and Development from the Head of the Soviet Delegation, Chairman of the Board of the State Bank of the U.S.S.R., Victor Gerashchenko.

37. ***Id.*** This additional expression of self-restraint would appear to have been superfluous in view of a further clause in Article 8.4 to the effect that, at the end of the three-year period, a decision to permit normal Bank operations in a country that had made a request pursuant to Article 8.4 would require action by a supermajority of not less than three-fourths of the Governors representing not less than 85 percent of total voting power. Agreement, ***supra*** note 3, Art. 8.4. This effectively gave a veto power to any two of the Bank's six largest shareholders: France, Germany, Italy, Japan and the United Kingdom, each of which holds about 8.5 percent, and the United States, which holds 10 percent of the Bank's capital stock.

38. Agreement, ***supra*** note 3, Art. 8.4(i).

39. ***Id.*** Art. 8.4(iii).

40. ***Id.*** Art. 56.2(ii)(requiring a supermajority vote for amendment of Article 8.4).

41. *See, e.g.*, Vienna Convention on the Law of Treaties, ***supra*** note 5, Art. 62.

42. Agreement, ***supra*** note 3, Art. 57.

43. Limitation on Financing and Operations Applicable to the Former USSR: Resolution of the Board of Directors, BDS92-2 (February 28, 1992). In view of the matter at issue, the Board of Directors referred its decision to the Board of Governors for approval by the supermajority vote required by Article 8.4 for removal of the financing limitation, and also by Article 56.2(ii) for any amendment of Article 8.4. At the same time, a final decision of the Board of Governors under Article 57.2 was requested by Japan, which had indicated its dissent on procedure. By Resolution No. 22, adopted on March 28, 1992, the Board of Governors approved the decision of the Board of Directors.

44. Agreement, ***supra*** note 3, Art. 13(v).

45. ***Id.*** Art. 29.3.

46. EBRD Board of Governors Resolution No. 30 (adopted October 9, 1992).

47. Agreement, *supra* note 3, Art. 5.1 (providing for a minimum initial subscription of 100 shares).

48. EBRD Board of Governors Resolution No. 31 (adopted October 9, 1992).

49. EBRD Board of Governors Resolution No. 34 (adopted January 15, 1993). As of this writing, neither the Republic of Bosnia and Herzegovina nor the Federal Republic of Yugoslavia (Serbia and Montenegro) has been admitted as a member of the Bank.

50. The four requisite characteristics for statehood under international law (a defined territory, a stable population, a government with authority over such population, and the capacity to enter into relations with other international legal persons) do not include the existence of a universally accepted name. *See* Montevideo Convention on Rights and Duties of States, December 26, 1933, Art. 1. The definition in the Restatement (Third) of the Foreign Relations Law of the United States § 201 (1986) is nearly identical.

51. EBRD Board of Governors Resolution No. 35 (adopted February 13, 1993).

52. EBRD Board of Governors Resolution No. 33 (adopted January 15, 1993). The effective date of membership was January 1, 1993, the date on which the Czech and Slovak Federal Republic ceased to exist and the two new states came into existence.

53. *See* Agreement, *supra* note 3, Art. 11.

54. Chairman's Report, *supra* note 10, Art. 2, note 1.

55. Agreement, *supra* note 3, Art. 11.1(v).

56. Article 11.3 sets forth as follows the proportion of the Bank's ordinary operations that may be devoted to the state sector:

> (i) Not more than forty (40) per cent of the amount of the Bank's total committed loans, guarantees and equity investments, without prejudice to its other operations referred to in this Article, shall be provided to the state sector. Such percentage limit shall apply initially over a two (2) year period, from the date of commencement of the Bank's operations, taking one year with another, and thereafter in respect of each subsequent financial year.
>
> (ii) For any country, not more than forty (40) per cent of the amount of the Bank's total committed loans, guarantees and equity investments over a period of five (5) years, taking one year with another, and without prejudice to the Bank's other operations referred to in this Article, shall be provided to the state sector.

Id. Art. 11.3(i), (ii).

57. The Portfolio Ratio, BDS92-101 (November 17, 1992).

58. Agreement, *supra* note 3, Art. 11.3(iii)(a).

59. *Id.* Art. 11.3(iii)(b).

60. The Portfolio Ratio, *supra* note 57.

61. *See* Portfolio Risk Management and Lending Policies, BDS91-50 (December 10, 1993).

62. Agreement, *supra* note 3, Annex A, "Recipient Countries."

63. *Id.*

64. Chairman's Report, *supra* note 10, Art. 2, note 1.

65. Agreement, *supra* note 3, Art. 2.2.

66. *See id.* Art. 24.2 (requiring such cooperation agreements to be authorized by the Board of Governors).

67. Kazakstan, the Kyrgyz Republic, and Uzbekistan have joined the ADB, while Azerbaijan, Tajikistan, and Turkmenistan are completing the formalities for membership.

68. All of the countries in which the Bank operates are now also members of the IBRD and the IFC.

69. IBRD, General Conditions Applicable to Loan and Guarantee Agreements for Single Currency Loans Dated February 9, 1993, § 9.03 (titled "Negative Pledge").

70. *Id.* § 9.03(a).

71. *Id.* § 9.03(a)(ii).

72. *See* Chairman's Report, *supra* note 10, note to Art. 14 (urging that state guarantees be used sparingly in the case of loans to state-owned enterprises moving to participation in the market economy). It notes that

> a state-owned enterprise would be more likely to respond quickly to market forces, and to make the transition to market-oriented economies, if that enterprise could not rely on a government guarantee to discharge its responsibilities under a Bank loan.

Id.

73. In its sovereign lending, the EBRD has the same interest as the IBRD in preventing other creditors from asserting a prior claim to the sovereign's foreign exchange assets or revenues. The EBRD's standard terms and conditions for loans to, or guaranteed by, a recipient state are modeled after the IBRD's General Conditions and contain a similar negative pledge undertaking.

74. The International Union of Credit and Investment Insurers (the Berne Union) works for "(i) the international acceptance of sound principles of export credit insurance and the establishment and maintenance of discipline in the terms of credit for international trade; and (ii) international cooperation in encouraging a favourable investment climate and in developing and maintaining sound principles of foreign investment insurance." 1 *Yearbook of International Organizations* 1079 (31st ed. 1994). Its membership consists of organizations from 33 countries. *Id.*

75. Waivers have been granted to the Russian Federation and Uzbekistan.

76. Chairman's Report, *supra* note 10.

77. *Id.* Introduction.

78. *The European Bank for Reconstruction and Development, supra* note 3, at 5.

79. Dunnett, *supra* note 5, at 576.

80. Gold, *supra* note 1, at 11.

Chapter 4, Comment (Munk)

1. 22 U.S.C. § 286a(a) (1994).

2. Agreement Establishing the European Bank for Reconstruction and Development, Art. 4, paragraph 2, *reprinted in* Ibrahim F.I. Shihata, *The European Bank for Reconstruction and Development: A Comparative Analysis of the Constituent Agreement* Appendix I (1990); *see* Shihata, *supra*, at 8.

3. 22 U.S.C. § 262m-7 (1994).

4. *See* Bradford W. Morse & Thomas R. Berger, *Sardar Sarovar: The Report of the Independent Commission* (1992).

5. *See id.*

6. *Id.* at 349–353.

7. 22 U.S.C. § 2370(a) (1994).

8. *Id.* § 2370a(b).

Chapter 5, "European Monetary Union and the European System of Central Banks" (C. Lichtenstein)

1. Special thanks are due to the law offices of S.G. Archibald, Paris, for their aid in the preparation of this paper while the author was resident in Paris.

2. Treaty Establishing the European Community, February 7, 1992, *incorporating changes made by* the Treaty on European Union, done at Maastricht, February 7, 1992, 1992 Official Journal of the European Communities [O.J.] (C 224), *reprinted in* 31 International Legal Materials 247 (1992). The amended treaty is hereinafter referred to as the E.C. Treaty. Selected provisions of the E.C. Treaty are reprinted in 3 *Current Legal Issues Affecting Central Banks* 325 (Robert C. Effros ed., 1995).

3. For a discussion of why the summer 1993 difficulties of the ERM may have strengthened the case for getting on with economic and monetary union, *see Europe's Monetary Future, From Here to EMU,* The Economist, U.K. Edition, October 23, 1993, at 25.

4. E.C. Treaty, *supra* note 2, Art. 109f(3).

5. A report prepared by Professor Jean-Victor Louis, Head of the Legal Department of the National Bank of Belgium, for the International Monetary Law Committee of the International Law Association describes this process. Jean-Victor Louis, *The Present State of the Monetary Integration Process in Europe—The European Monetary Institute*, Report to the Monetary Law Committee of the International Law Association (January 1994).

6. E.C. Treaty, *supra* note 2, Art. 189.

7. Two introductory texts are T.C. Hartley, *The Foundations of European Community Law* (2d ed. 1991) and P.J.G. Kapteyn & P. Verloren van Themaat, *Introduction to the Law of the European Communities.* (Lawrence Gormley ed., 1991).

8. *Factortame Ltd. v. Secretary of State for Transportation*, 1 All England Law Reports 70 (1991).

9. E.C. Treaty, *supra* note 2, Art. 164.

10. *Id.* Art. 169.

11. *Id.* Art. 171(1).

12. *Id.* Art. 171(2).

13. *Id.* Arts. 173, 175.

14. *Id.* Arts. 176, 171.

15. *Id.* Art. 177.

16. *Id.*

17. *Id.* Arts. 169, 177.

18. Louis, *supra* note 5, at 9.

19. E.C. Treaty, *supra* note 2, Art. 109f, last paragraph.

20. Louis, *supra* note 5, at 18.

21. E.C. Treaty, *supra* note 2, Arts. 173, 175–177, 180. Article 180(d) gives to the Council of the ECB in respect of national central banks the same powers as the Commission has over member states under Article 169. *See supra* text accompanying note 10.

22. *Id.* Art. 109f(6). In fact, the EMI may have some real power in the area of reviewing member state draft legislation. Article 109f(6) of the E.C. Treaty and Article 5.3 of the EMI's Statute provide that, within the limits and conditions of the Council's implementing legislation, the EMI "shall be consulted by the authorities of the member states" on draft legislation. The Council has enacted the implementing legislation. (Council Decision 93/717 of 22 November 1993 on the Consultation of the European Monetary Institute by the Authorities of the Member States on Draft Legislative Provisions, 1993 O.J. (L 332).) This Decision gives a list of legislative matters considered to be within the EMI's competence, including (among others) "the status and powers of national central banks and the instruments of monetary policy" and "rules applicable to financial institutions in so far as they influence the stability of financial institutions and markets." *Id.* Art. 1. One can speculate that, if a member state were to exempt its large financial houses from, say, prudential supervision of participants in the derivative markets without consulting the EMI, the EMI might very well have a judiciable complaint.

23. E.C. Treaty, *supra* note 2, Art. 109f(2), (3).

24. *Id.* Art. 109f(3).

25. Protocol on the Statute of the European Monetary Institute, annexed to the E.C. Treaty, *supra* note 2, Art. 15.

26. *Id.* Art. 15.4.

27. *Id.* Arts. 15.4, 3.1.

28. E.C. Treaty, *supra* note 2, Art. 109j.

29. *Id.*; Protocol on the Statute of the European System of Central Banks and the European Central Bank, annexed to the E.C. Treaty, *supra* note 2, [hereinafter ESCB Protocol].

30. ESCB Protocol, *supra* note 29, Art. 1.1; E.C. Treaty, *supra* note 2, Art. 4a.

31. E.C. Treaty, *supra* note 2, Art. 105(2).

32. *Id.*

33. *Id.* Art. 105(5), (6).

34. *Id.* Art. 105a(1).

35. E.C. Treaty, *supra* note 2, Art. 106(3).

36. ESCB Protocol, *supra* note 29, Art. 8.

37. *Id.* Art. 9.2.

38. *Id.* Art. 14.3.

39. *Id.*; E.C. Treaty, *supra* note 2, Art. 180, *discussed* in text at note 21 *supra*.

40. E.C. Treaty, *supra* note 2, Art. 173.

41. *Id.* Art. 109b(1) and (2).

42. *Id.* Art. 173.

43. *Id.* Art. 105(6).

44. *Id.* Art. 105(5).

45. *Id.* Art. 105(4); *see* text at note 22 *supra* for the similar point in the EMI.

46. The Council has set forth limits and conditions on consultations with the EMI. *See supra* note 22.

47. Protocol on Certain Provisions Relating to Denmark, annexed to the E.C. Treaty, *supra* note 2; Protocol on Certain Provisions Relating to the United Kingdom of Great Britain and Northern Ireland, annexed to the E.C. Treaty, *supra* note 2.

48. E.C. Treaty, *supra* note 2, Art. 109k; ESCB Protocol, *supra* note 29, Chapter IX.

49. E.C. Treaty, *supra* note 2, Art. 109k(1).

50. *Id.* Arts. 105, 105a, 108a, 109.

51. *Id.* Art. 109a(2)(b); Protocol on Certain Provisions Relating to the United Kingdom of Great Britain and Northern Ireland, annexed to the E.C. Treaty, *supra* note 2, paragraph 7.

52. ESCB Protocol, *supra* note 29, Art. 43.2. Remember, however, that national law has been amended in accordance with the E.C. Treaty, affecting, for example, the independence of the central bank.

53. *Id.* Art. 47.

Chapter 5, Comment (Lastra)

1. The Treaty Establishing the European Economic Community, March 25, 1957, 298 United Nations Treaty Series 11 [hereinafter E.C. Treaty] was amended by the Treaty on European Union, done February 7, 1992, 1992 Official Journal of the European Communities [O.J.] (C 224) 1 [hereinafter Maastricht Treaty], *reprinted* in 31 International Legal Materials 247 (1992). Selected provisions of the E.C. Treaty are reprinted in 3 *Current Legal Issues Affecting Central Banks* 325 (Robert C. Effros ed., 1995).

2. Article G(A) of the Maastricht Treaty, *supra* note 1, provides that throughout the Treaty, "[t]he term 'European Economic Community' shall be replaced by the term 'European Community'."

3. *See id.* Art. A; Ruling of the German Federal Constitutional Court of October 12, 1993, Part A.I.1(a).

4. *See* E.C. Treaty, *supra* note 1, Art. 8a (as revised by the Single European Act, 1987 O.J. (L 169), *reprinted in* 1 *Treaties Establishing the European Communities* 207, 227 (1987)).

5. The Single European Act, *supra* note 4, inserted a new Chapter 1, entitled "Cooperation in Economic and Monetary Policy (Economic and Monetary Union)," in Part Three, Title II of the E.C. Treaty, *supra* note 1. The new Article 102a, which was the only provision in

the new chapter, reads as follows:

1. In order to ensure the convergence of economic and monetary policies which is necessary for the further development of the Community, Member States shall cooperate in accordance with the objectives of Article 4. In so doing, they shall take account of the experience acquired in cooperation within the framework of European Monetary System (EMS) and in developing the ECU, and shall respect existing powers in this field.
2. Insofar as further development in the field of economic and monetary policy necessitates institutional changes, the provisions of Article 236 shall be applicable. The Monetary Committee and the Committee of Governors of the Central Banks shall also be consulted regarding institutional changes in the monetary area.

6. The EMI also replaced the European Monetary Cooperation Fund. *See* E.C. Treaty, *supra* note 1, Art. 109f.

7. Mr. Tietmeyer, the Bundesbank's president, speaking at the annual meeting of the World Economic Forum in Davos, ruled out transferring any of its currency reserves to the newly established European Monetary Institute. Ian Rodger, ***Bundesbank Will Not Pass Reserves to EMI***, Financial Times, January 31, 1994, at 2. Mr. Tietmeyer stressed the advisory role of the EMI and said that "he did not believe lasting monetary union could be achieved without a parallel political union of EU countries." ***Id.***

8. Although the Bundesrat and the Bundestag approved the Maastricht Treaty in December 1992, full ratification came only after the favorable ruling of the German Federal Constitutional Court of October 12, 1993. Germany was the last country to ratify the Maastricht Treaty, even though the ESCB has been largely patterned upon the Bundesbank model.

9. *See, e.g.*, Charles Goodhart, ***ERM and EMU*** (1993)(unpublished mimeo presented in 1993 at the Columbia School of International and Public Affairs).

10. ***Id.*** at 23.

11. Mr. Lamfalussy said that wider ERM bands "should be preserved in order to defend currencies against speculative pressures." Lionel Barber, ***Eurocurrency 'A Realistic Option': Lamfalussy Offers Optimistic Assessment of EU Economies***, Financial Times, September 7, 1994, at 22.

12. Article 109j(1) of the E.C. Treaty, ***supra*** note 1, spells out these criteria of economic convergence:

- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability.
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104c(6);
- the observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;
- the durability of convergence achieved by the Member State and its participation in the Exchange Rate Mechanism of the European Monetary System being reflected in long-term interest rate levels.

13. Article N(2) of the Maastricht Treaty, ***supra*** note 1, reads as follows:

A conference of representatives of the governments of the Member States shall be convened in 1996 to examine those provisions of this Treaty for which revision is provided, in accordance with the objectives set out in Articles A and B.

14. E.C. Treaty, ***supra*** note 1, Art. 104c.

15. ***Id.***

16. ***Id.*** Art. 104c(6).

17. Ruling of the German Federal Constitutional Court of October 12, 1993, Part C.II.2.d2(3) and d2(5).

18. *See* ***The Second Stage of European Economic and Monetary Union***, 46 Deutsche Bundesbank Monthly Reports 23–24 (January 1994). For previous declarations on this issue, ***see also The Recent Monetary Policy Decisions and Developments in the European Monetary System***, 45 Deutsche Bundesbank Monthly Reports 19, 27 (August 1993); ***The Maastricht Decisions on the European Economic and Monetary Union***, 44 Deutsche Bundesbank Monthly Reports 43, 52 (February 1992).

19. A vague expression from a legal point of view.

20. Maastricht Treaty, ***supra*** note 1, Art. N(1).

21. Ruling of the German Constitutional Court of October 12, 1993, Part C.II.2.d2(1) (emphasis added).

22. Maastricht Treaty, ***supra*** note 1, Art. N(1).

23. The European Parliament ratified the accession treaties of Austria, Finland, Norway, and Sweden on May 5, 1994. However, the people of Austria, Finland, and Sweden voted in favor of EU membership in referendums held, respectively, in June, October, and November 1994, while the Norwegians rejected membership in the Union in a referendum also held in November 1994. Several Eastern European countries are pursuing membership in the Union.

24. *See* Council Regulation 3603/93 of 13 December 1993 Specifying Definitions for the Application of the Prohibition Referred to in Articles 104 and 104b(1) of the Treaty, 1993 O.J. (L 332) 1, ***reprinted in*** 3 ***Current Legal Issues Affecting Central Banks, supra*** note 1, at 349. Council Regulation 3604/93 of 13 December 1993 Specifying Definitions for the Application of the Prohibition of Privileged Access Referred to in Article 104a of the Treaty, 1993 O.J. (L 332) 4, ***reprinted in*** 3 ***Current Legal Issues Affecting Central Banks, supra*** note 1, at 354.

25. *See* Council Regulation 3065/93 of 22 November 1993 on the Application of the Protocol on the Excessive Deficit Procedure, Art. 4, 1993 O.J. (L 332) 7, ***reprinted in*** 3 ***Current Legal Issues Affecting Central Banks, supra*** note 1, at 382.

26. Protocol on the Excessive Deficit Procedure, annexed to the E.C. Treaty, ***supra*** note 1, Art. 1, ***reprinted in*** 3 ***Current Legal Issues Affecting Central Banks, supra*** note 1, at 380.

27. *See* Council Decision 93/716/EC of 22 November 1993 on the Statistical Data to be used for the Determination of the Key for the Financial Resources of the European Monetary Institute, 1993 O.J. (L 332) 12.

28. *See* Council Decision 93/717/EC of 22 November 1993 on the Consultation of the European Monetary Institute by the authorities of the Member States on Draft Legislative Provisions, 1993 O.J. (L 332) 14.

29. E.C. Treaty, ***supra*** note 1, Art. 108; see Robert C. Effros, ***The Maastricht Treaty, Independence of the Central Bank, and Implementing Legislation, in Frameworks for Monetary Stability: Policy Issues and Country Experiences*** 279 (Tomás J.T. Baliño & Carlo Cottarelli eds., 1994).

30. Autonomía del Banco de España [Law of the Autonomy of the Banco de España], Law 13/1994 of June 1, 1994, Boletín Oficial del Estado [Official State Gazette] No. 13, June 2, 1994; ***see*** Gesetz zur Änderung von Vorschriften über die Deutsche Bundesbank, Bundesgesetzblatt, Teil 1 [German Federal Law Gazette, Title 1], July 8, 1994.

31. Law of the Autonomy of the Banco de España, ***supra*** note 30.

32. Gesetz zur Änderung von Vorschriften über die Deutsche Bundesbank, ***supra*** note 30.

33. *Id.*

34. *Id.*

35. E.C. Treaty, ***supra*** note 1, Arts. 108, 109e(5).

36. *See* Centre for Economic Policy Research, ***Independent and Accountable: A New Mandate for the Bank of England*** (1993) (report of an independent panel chaired by Eric Roll); House of Commons Treasury and Civil Service Select Committee, 1 ***The Role of the***

Bank of England (First Report, together with the Proceedings of the Committee, 1993–94 Session)(December 8, 1993).

37. Following this "wave of change," economic literature in the field of central bank independence has flourished in the last few years: Robin Bade & Michael Parkin, *Central Bank Laws and Monetary Policy* (1978)(unpublished mimeo); Don Fair, *The Independence of Central Banks*, 129 The Banker 31 (October 1979); King Banaian *et al.*, *Central Bank Independence: An International Comparison, Economic Review*, Federal Reserve Bank of Dallas 1 (March 1983); Alberto Alesina, *Macroeconomics and Politics*, *in* NBER Macroeconomic Annual 1988 at 1 (Stanley Fischer ed., 1988) and *Politics and Business Cycles in Industrial Democracies*, 4 Economic Policy 57 (1989); Marta Castello-Branco & Mark Swinburne, *Central Bank Independence: Issues and Experience*, IMF Working Paper No. 91/58 (1991); Vittorio Grilli *et al.*, *Political and Monetary Institutions and Public Financial Policies in the Industrial Countries*, 6 Economic Policy 342 (1991); Alex Cukierman, *Central Bank Strategy, Credibility, and Independence: Theory and Evidence* (1992); Adam Posen, *Why Central Bank Independence Does Not Cause Low Inflation: There is No Institutional Fix for Politics*, The Amex Bank Review (1993); Charles Goodhart, *Central Bank Independence*, London School of Economics and Political Science Working Paper No. 57 (November 1993); Stanley Fischer, *Modern Central Banking* (1994)(presented at the Bank of England's tercentenary celebration). Further elaboration on the legal aspects of central bank independence can be found in Rosa Maria Lastra, *The Independence of the European System of Central Banks*, 33 Harvard International Law Journal 475 (1992).

38. Developments in Venezuela following the resignation of Ms. Ruth de Krivoy in April 1994 (citing the Government's actions affecting the bank's independence) illustrate the threat that many independent central banks face. *See* Joseph Mann, *Caracas Under Fire as Governor Quits: Latin American Central Banks Pushed to Centre Stage*, Financial Times, April 28, 1994, at 6.

39. E.C. Treaty, *supra* note 1, Art. 104(1).

40. In the United Kingdom, a recent change in the relationship between the Treasury and the Bank of England has provided for more accountability in terms of monetary disclosure. The decisions on interest rates will now be regularly taken at monthly meetings, and the minutes of these monthly monetary meetings between the Bank of England and the Treasury will *be published after a six-week interval. See* David Marsh, *UK Monetary Disclosure Wins No Converts: Eddie George's European Union Confreres Take a Fairly Dim View of Transparency*, Financial Times, April 21, 1994, at 2.

41. Gesetz über die Deutsche Bundesbank [The Bundesbank Act], as amended up to October 22, 1992, Art. 3 (English translation prepared by the Bundesbank).

42. Robert Sparve, *Independence of Central Banks: The Swedish Central Bank, in* 3 *Current Legal Issues Affecting Central Banks*, *supra* note 26, at 225.

43. The Sveriges Riksbank Act (1988:1385), issued on December 8, 1988 as amended up to and including January 1, 1994, Art. 4 (English translation prepared by the Sveriges Riksbank).

44. *See* Michele Fratianni, Jürgen von Hagen, and Christopher Waller, *The Maastricht Way to EMU*, *in Princeton Essays in International Finance* 35 (No. 187, June 1992) (recalling that Former German Chancellor H. Schmidt wrote in his memoirs that "he regarded exchange-rate policies . . . *as important elements of general foreign and strategic policy*") (emphasis added).

45. *See, e.g.*, Dani Rodrik, *Trade Liberalization in Disinflation*, Remarks at the Princeton Conference Celebrating the Fiftieth Anniversary of Essays in International Finance (April 1993).

46. E.C. Treaty, *supra* note 1, Arts. 109, 105(2).

47. *Id.* Art. 105(5), (6).

Chapter 6, "The European Community's Second Banking Directive" (Smits)

1. Treaty Establishing the European Coal and Steel Community, April 18, 1951.

The following legal writings may be of additional interest: ***Financial Services and EEC Law: Materials and Cases*** (Martijn van Empel ed., looseleaf)(containing EC banking, insurance, and securities directives); ***Banking and EC Law: Commentary*** (Martijn van Empel & René Smits eds., looseleaf); George S. Zavvos, ***Towards a European Banking Act***, 25 Common Market Law Review 263 (1988); Paolo Clarotti, ***Un pas décisif vers le marché commun des banques: la deuxième directive de coordination en matière d'établissements de crédit***, Revue du Marché Commun 453 (1989); Paolo Clarotti, ***Vers un marché unique des banques***, Cahiers de Droit Européen 504 (1989); ***The Single Market and the Law of Banking*** (Ross Cranston ed., 1991); ***Financial Services in the New Europe, in The Comparative Law Yearbook of International Business*** (Dennis Campbell & Mickela Moore eds., Special Issue 1992); Sherman E. Katz, ***The Second Banking Directive***, 12 Yearbook of European Law 249 (1992); Robert Strivens, ***The Liberalization of Banking Services in the Community***, 29 Common Market Law Review 283 (1992).

2. Treaty Establishing the European Economic Community, March 25, 1957. The Treaty's name was changed to the Treaty Establishing the European Community [E.C. Treaty] after it was amended by the Treaty on European Union, signed in Maastricht on February 7, 1992, 1992 Official Journal of the European Communities [O.J.] (C 191) 1.

3. Treaty Establishing the European Atomic Energy Community, March 25, 1957.

4. Single European Act, signed in Luxembourg on February 17, 1986 and in The Hague on February 28, 1986, 1987 O.J. (L 169) 1.

5. Treaty on European Union, ***supra*** note 2.

6. Council of the European Communities and Commission of the European Communities, Agreement on the European Economic Area, May 2, 1992.

7. Second Council Directive 89/646 of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 O.J. (L 386) 1, as corrected 1990 O.J. (L 83) 128 and 1990 O.J. (L 158) 87 [hereinafter Second Banking Directive], ***reprinted in*** 2 ***Current Legal Issues Affecting Central Banks*** 251 (Robert C. Effros ed., 1994).

8. ***Id.***

9. First Council Directive 77/780 of 12 December 1977 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, Art. 1, 1977 O.J. (L 322) 30, as amended [hereinafter First Banking Directive], ***reprinted in*** 2 ***Current Legal Issues Affecting Central Banks***, ***supra*** note 7, at 251.

10. Second Banking Directive, ***supra*** note 7, Art. 24.

11. Council Directive 89/647 of 18 December 1989 on a Solvency Ratio for Credit Institutions, 1989 O.J. (L 386) 14, as amended [hereinafter Solvency Ratio Directive], ***reprinted in*** 2 ***Current Legal Issues Affecting Central Banks***, ***supra*** note 7, 297; Council Directive 89/299 on the Own Funds of Credit Institutions, 1989 O.J. (L 124) 16, as amended [hereinafter Own Funds Directive], ***reprinted*** in 2 ***Current Legal Issues Affecting Central Banks***, ***supra***, 287.

12. Second Banking Directive, ***supra*** note 7; Solvency Ratio Directive, ***supra*** note 11; Own Funds Directive, ***supra*** note 11.

13. Basle Committee on Banking Supervision, ***Report of the Basle Committee on International Convergence of Capital Measurement and Capital Standards*** (July 1988 as amended in 1992 and 1995). The text of the Basle Capital Accord is reprinted in 1 ***Current Legal Issues Affecting Central Banks*** 487 (Robert C. Effros ed., 1992). The 1992 amendment is reprinted in 3 ***Current Legal Issues Affecting Central Banks*** 296 (Robert C. Effros ed., 1995). Further amendments are reprinted herein as Appendix II(11).

14. *See, e.g.*, Case 33/74, Van Binsbergen, 1974 European Court Reports [E.C.R.] 1299; Joined Cases 110 & 111/78, Van Wesemael, 1979 E.C.R. 35; Case 279/80, Webb, 1981 E.C.R. 3305.

15. Second Banking Directive, ***supra*** note 7, Title II (titled "Harmonization of Authorization Conditions").

16. ***Id.*** Title III (regarding "[r]elations with third countries").

17. ***Id.*** Title V (titled "Provisions Relating to the Freedom of Establishment and the Freedom to Provide Services").

18. ***Id.*** Title VI.

19. ***Id.*** Annex.

20. First Banking Directive, ***supra*** note 9, Art. 1.

21. Second Banking Directive, ***supra*** note 7, Annex.

22. First Banking Directive, ***supra*** note 9, Art. 3(2).

23. Second Banking Directive, ***supra*** note 7, Art. 4(1).

24. ***Id.*** Art. 4(2).

25. First Banking Directive, ***supra*** note 9, Art. 3(2).

26. Jan Willem van der Vossen, ***Authorization Requirements in Banking & EC Law*** Chapter 4, at 17 (Martijn van Empel & René Smits eds., 1992).

27. First Banking Directive, ***supra*** note 9, Art. 3(2).

28. *See, e.g.,* Loi no. 84-46 du 24 janvier 1984 relative à l'activité et au contrôle des ètablissements de crédit, modifiée § 13; Wet van 22 maart 1993 op het statuut van en het toezicht op de kredietinstellingen, as amended, § 19, Belgisch Staatsblad, April 19, 1993.

29. First Banking Directive, ***supra*** note 9, Art. 13; Convention for the Protection of Human Rights and Fundamental Freedoms, entered into force September 3, 1953, Art. 6, 213 United Nations Treaty Series 221 (in part providing that "[i]n the determination of his civil rights and obligations or of any criminal charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law").

30. Second Banking Directive, ***supra*** note 7, Art. 5.

31. ***Id.***

32. ***Id.*** Art. 11.

33. ***Id.*** Art. 5.

34. ***Id.*** Art. 11.

35. First Banking Directive, ***supra*** note 9, Art. 3(4).

36. Second Banking Directive, ***supra*** note 7, Art. 13(2).

37. Solvency Ratio Directive, ***supra*** note 11, Arts. 3(7), 10.

38. Second Banking Directive, ***supra*** note 7, Art. 9.

39. E.C. Treaty, ***supra*** note 2, Art. 38.

40. Second Banking Directive, ***supra*** note 7, Art. 9.

41. ***Id.*** Art. 9(3).

42. ***Id.*** Art. 9(4).

43. ***Id.***

44. ***Id.*** Art. 43(2).

45. General Agreement on Trade in Services, ***in*** The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Part II, Annex 1B (December 15, 1993). The General Agreement on Trade in Services is reprinted herein as Appendix I(1).

46. Annex on Financial Services, ***in*** The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, ***supra*** note 45, Part II, Annex 18, at 29. The Annex on Financial Services, as part of the General Agreement on Trade in Services, can be found herein on Appendix I(1).

47. Organization for Economic Cooperation and Development, ***Code of Liberalization of Capital Movements*** (November 1990); OECD, ***Code of Liberalization of Current Invisible Transactions*** (March 1992).

48. E.C. Treaty, ***supra*** note 2, Art. 73b.

49. *Id.*

50. *Id.* Art. 73c.

51. *See **supra*** note 11.

52. Council Directive 92/30 of 6 April 1992 on the Supervision of Credit Institutions on a Consolidated Basis, 1992 O.J. (L 110) 52, as corrected 1992 O.J. (L 280) 54, ***reprinted in*** 3 *Current Legal Issues Affecting Central Banks* 431 (Robert C. Effros ed., 1995); Council Directive 86/635 of 8 December 1986 on the Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions, 1986 O.J. (L 372) 1, ***reprinted in*** 3 *Current Legal Issues Affecting Central Banks*, ***supra***, at 389; Council Directive 92/121 of 21 December 1992 on the Monitoring and Control of Large Exposures of Credit Institutions, 1993 O.J. (L 29) 1, ***reprinted in*** 3 *Current Legal Issues Affecting Central Banks*, ***supra***, at 444; Council Directive 93/6 of 15 March 1993 on the Capital Adequacy of Investment Firms and Credit Institutions, 1993 O.J. (L 141) 1 [hereinafter Capital Adequacy Directive], ***reprinted in*** 3 *Current Legal Issues Affecting Central Banks*, ***supra***, at 497.

53. Second Banking Directive, ***supra*** note 7, Art. 10.

54. *Id.* Art. 11.

55. *Id.* Art. 12.

56. *Id.* Art. 13(2).

57. Solvency Ratio Directive, ***supra*** note 11; Capital Adequacy Directive, ***supra*** note 52.

58. *See, e.g.*, Act on the Supervision of the Credit System, 1992, as amended, § 24, Staatsblad 1992, No. 722 (Netherlands).

59. Second Banking Directive, ***supra*** note 7, Arts. 1, 11(1).

60. *Id.* Art. 1.

61. *Id.* Art. 12(1).

62. *Id.* Art. 12(2).

63. *Id.* Art. 12(3), (4), (5).

64. *Id.* Art. 12(7).

65. Council Directive 89/592 of 13 November 1989 Coordinating Regulations on Insider Dealing, 1989 O.J. (L 334) 30.

66. Second Banking Directive, ***supra*** note 7, Art. 13.

67. *Id.* Art. 13(3).

68. Article 52 of the E.C. Treaty, ***supra*** note 2, provides:

> Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a member-State in the territory of another member-state shall be abolished by progressive stages in the course of the transitional period. Such progressive abolition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any member-state established in the territory of any member-state.
>
> Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 58, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital.

69. *Id.* Art. 57.

70. *See* the Insurance Cases: Case 205/84, Commission v. Germany, 1986 E.C.R. 3755; Case 220/83, Commission v. France, 1986 E.C.R. 3663; Case 252/83, Commission v. Denmark, 1986 E.C.R. 3713; Case 206/84, Commission v. Ireland, 1986 E.C.R. 3817.

71. *See* Webb and Van Wesemael, ***supra*** note 14.

72. Case 120/78, Cassis de Dijon, E.C.R. 649.

73. *See* case law and secondary legislation adopted under E.C. Treaty, *supra* note 2, Arts. 30 *et seq.* and 59 *et seq.*

74. Second Banking Directive, *supra* note 7, Art. 19.

75. First Banking Directive, *supra* note 9, Art. 3.

76. Second Banking Directive, *supra* note 7, Art. 19.

77. *Id.* Art. 19(3).

78. *Id.* Art. 20.

79. *Id.* Art. 7.

80. First Banking Directive, *supra* note 9, Art. 7, as amended by Article 14(1) of the Second Banking Directive, *supra* note 7.

81. First Banking Directive, *supra* note 9, Art. 12.

82. *Id.* Art. 7

83. See *id.* Art. 12.

84. E.C. Treaty, *supra* note 2, Art. 109f.

85. *Id.* Art 105(6).

86. *See supra* note 11.

87. Council Directive 92/30, *supra* note 52.

88. Council Directive 92/121, *supra* note 52.

89. Council Directive 94/19 of 30 May 1994 on Deposit-Guarantee Schemes, 1994 O.J. (L 135) 5, *reprinted herein as* Appendix III (1).

90. Capital Adequacy Directive, *supra* note 52.

91. *Inquiry into the Supervision of the Bank of Credit and Commerce International* (The Right Honorable Lord Justice Bingham, chairman, October 22, 1992).

92. E.C. Treaty, *supra* note 2, Art. 189b.

93. Council Directive 95/26 of June 29, 1995, Art. 2(2) 1995 O.J. (L 168) 7 [hereinafter Post-BCCI Directive]. The Post-BCCI Directive, as this directive is commonly named, was adopted after this chapter was written. References in these endnotes are to the text of the directive as adopted.

94. *See id.* Art. 2(2).

95. First Banking Directive, *supra* note 9, Art. 8(1)(c).

96. The final sentence of Article 6(1) of the Post-BCCI Directive provides that this date shall be July18, 1996.

97. *See* Post-BCCI Directive, *supra* note 92, Art.3.

98. Second Banking Directive, *supra* note 7, Preamble.

99. Post-BCCI Directive, *supra* note 92, Art. 4.

100. *Id.* Art. 5.

101. Solvency Ratio Directive, *supra* note 11, Art. 3(4).

102. *See, e.g.,* Case 33/74, Van Binsbergen, 1974 E.C.R. 1299, confirmed by Case C-148/91, Verenigeng Veronica Omroep Organisatie/Commissariaat voor de Media, Proceedings of the Court of Justice and the Court of First Instance of the European Communities, No. 04-93.

Chapter 7, "Banking Law Developments in the European Union: Deposit Insurance and Money-Laundering Initiatives" (Clarotti)

1. First Council Directive 77/780 of 12 December 1977 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, Art. 1, 1977 Official Journal of the European Communities [O.J.] (L 322) 30, *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 251 (Robert C. Effros ed., 1994).

2. *Id.* Recitals.

3. Second Council Directive 89/646 of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 O.J. (L 386) 1 [hereinafter Second Banking Directive], *reprinted in* 2 *Current Legal Issues Affecting Central Banks*, *supra* note 1, at 264.

4. Council Directive 89/647 of 18 December 1989 on a Solvency Ratio for Credit Institutions, 1989 O.J. (L 386) 14, *reprinted in* 2 *Current Legal Issues Affecting Central Banks*, *supra* note 1, at 297.

5. *See* Treaty Establishing the European Community, February 7, 1992, as amended by the Treaty on European Union, February 7, 1992, 1992 O.J. (C 224) 1 [hereinafter E.C. Treaty], Title III, Chapter 3 (titled "Services").

6. Council Directive 88/361 of 24 June 1988 for the Implementation of Article 67 of the Treaty, 1988 O.J. (L 178) 5; Second Banking Directive, *supra* note 3.

7. The Agreement on the European Economic Area was signed on May 2, 1992 and entered into force on January 1, 1994.

8. Council Directive 94/19 of 30 May 1994 on Deposit-Guarantee Schemes, 1994 O.J. (L 135) 5, *reprinted herein as* Appendix III(1).

9. Council Directive 91/308 of 10 June 1991 on Prevention of the Use of the Financial System for the Purpose of Money Laundering, 1991 O.J. (L 166) 77 [hereinafter Money-Laundering Directive], *reprinted in* 3 *Current Legal Issues Affecting Central Banks* 420 (Robert C. Effros ed., 1995).

10. Commission Recommendation 87/63 of 22 December 1986 Concerning the Introduction of Deposit-Guarantee Schemes in the Community, *reprinted in* 1 *Financial Services and EEC Law* Part III.C.26 (Martijn van Empel ed., 1994).

11. *Id.* paragraph 3.

12. *Id.* paragraph 1.

13. *Id.* Recitals.

14. *Id.*

15. Proposal for a Council Directive on Deposit-Guarantee Schemes, 1992 O.J. (C 163) 6.

16. Lov on en indskydergarantifond, October 28, 1987.

17. The "Fondo Interbancario di Tutela dei Depositi" was approved on November 4, 1987 by the General Assembly of the member banks.

18. Banking Act, Chapter 5 (deposit protection), July 12, 1989.

19. The Système de garantie des dépôts was approved on October 2, 1989 by the General Assembly of the Association pour la garantie des dépôts.

20. Law No. 2324 of July 17, 1995.

21. Decree-law No. 246/95 of September 19, 1995.

22. Proposed Directive, *supra* note 15.

23. Twenty-fifth meeting (of November 16, 1989) of the Banking Advisory Committee (text not available without prior approval of the Committee).

24. Proposed Directive, *supra* note 15, Art. 4(1).

25. *Id.* Art. 4(4).

26. *Id.* Art. 1.

27. *Id.* Art. 7(2).

28. *Id.* Annex (list of deposits referred to in Art. 4(2).

29. *Id.* Art. 2(1), first sentence.

30. *Id.* Art. 2(1), second sentence.

31. *Id.* Art. 2(2).

32. Proposal for a Council Directive on Deposit-Guarantee Schemes, Art. 4, 1992 O.J. (C 163) 6, as amended, 1993 O.J. (C 178) 14.

33. *Id.* Art. 2.

34. *Id.* Art. 7.

35. Common Position adopted by the Council on October 25, 1993, Art. 4(1), first sentence. *See* 1993 O.J. 9(C 314) 1.

36. Common position, *supra* note 35, Art. 4(1), second sentence.

37. E.C. Treaty, *supra* note 5, Art. 189b.

38. Council Directive 94/19, *supra* note 8.

39. Drug Trafficking Offenses Act, 1986, Chapter 32; Criminal Justice (Scotland) Act, 1987, Chapter 41; Criminal Justice Act, 1988, Chapter 33; Prevention of Terrorism (Temporary Provisions) Act, 1989, Chapter 4; Criminal Justice (International Co-Operation) Act, 1990, Chapter 5; Northern Ireland (Emergency Provisions) Act, 1991, Chapter 24; Criminal Justice Act, 1993, Chapter 36; Money-Laundering Regulations, 1993, Statutory Instruments 1993, No. 1933.

40. United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, December 19, 1988 [hereinafter Vienna Convention], *reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 1, at 375.

41. Basle Committee on Banking Regulations and Supervisory Practices, *Statement on Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering* (December 1988) [hereinafter Basle Statement of Principles], *reprinted in* 2 *Current Legal Issues Affecting Central Banks*, *supra* note 1, at 327.

42. *See* Michael F. Zeldin, *Money Laundering: Legal Issues, reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 1, at 209, 219; Financial Action Task Force on Money Laundering, *Report of February 6, 1990*, *reprinted in* 2 *Current Legal Issues Affecting Central Banks*, *supra* note 1, at 350.

43. Money-Laundering Directive, *supra* note 9.

44. *See* Fletcher N. Baldwin, Jr. & Robert J. Munro, *European Community* 4 (February 1993), *in International Money Laundering, Asset Forfeiture and International Financial Crimes* (1994).

45. Money-Laundering Directive, *supra* note 9, Art. 16.

46. *Id.* Art. 1.

47. *Id.* Art. 12.

48. *Id.* Art. 13.

49. *Id.* Art. 1.

50. Basle Statement of Principles, *supra* note 41; Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crime, September 8, 1990 [hereinafter Council of Europe Convention], *reprinted in* 2 *Current Legal Issues Affecting Central Banks*, *supra* note 1, at 331; Financial Action Task Force on Money Laundering, *Report of February 6, 1990*, *reprinted in* 2 *Current Legal Issues Affecting Central Banks*, *supra* note 1, at 350.

51. Money-Laundering Directive, *supra* note 9, Art. 3(2).

52. *Id.* Art. 3(5).

53. *Id.* Art. 4.

54. *Id.* Art. 5.

55. *Id.* Art. 11.

56. *Id.* Recitals (stating "[w]hereas ensuring that credit and financial institutions examine with special attention any transaction which they regard as particularly likely, by its nature, to be related to money laundering is necessary in order to preserve the soundness and integrity of the financial system as well as to contribute to combating this phenomenon; whereas to this end they should pay special attention to transactions with third countries which do not apply comparable standards against money laundering to those established by the Community or to other equivalent standards set out by international fora and endorsed by the Community. . . .").

57. *Id.* Art. 6.

58. Vienna Convention, *supra* note 40.

59. *Id.* Art. 6.

60. *Id.* Art. 11; Bank of England, *Money Laundering: Guidance Notes for Banks and Building Societies*, Section V, "Recognition of Suspicious Transactions."

61. Vienna Convention, *supra* note 40, Art. 13.

62. *Id.* Art. 11.

63. Financial Action Task Force on Money Laundering, *supra* note 50.

64. *Id.*

65. Statement by the Representatives of the Governments of the Member States Meeting within the Council (annexed to the Money-Laundering Directive, *supra* note 9); Vienna Convention, *supra* note 40; Council of Europe Convention, *supra* note 50.

66. *See supra* note 7.

67. This chapter is based on a speech made by José Luis Rorelle, Principal Administrator in the European Commission, at the Conference on Money Laundering held at the Council of Europe in Strasbourg on September 28–30, 1992.

Chapters 6 and 7, Comment (Key)

1. *See* Sydney J. Key, *Is National Treatment Still Viable? U.S. Policy in Theory and Practice,* 5 Journal of International Banking Law 365 (1990); *see also* Robert C. Effros, *Comments on "Regulation of Foreign Banks' Entry into the United States under FBSEA: Implementation and Implications," A Paper Presented by Deborah Burand*, 24 Law & Policy in International Business 1125 (1992).

2. General Agreement on Trade in Services, *in* The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations (December 15, 1993), *reprinted herein* as Appendix I(1); Organization for Economic Cooperation and Development, *Declaration on International Investment and Multinational Enterprises*, June 21, 1976, 15 International Legal Materials 967 (1976).

3. *See* Sydney J. Key, *Mutual Recognition: Integration of the Financial Sector in the European Community*, 75 Federal Reserve Bulletin 591 (1989).

4. Second Council Directive 89/646 of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 Official Journal of the European Community [O.J.] (L 386) 1, as corrected 1990 O.J. (L 83) 128 and 1990 O.J. (L 158) 87, Art. 6 [hereinafter Second Banking Directive], *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 251 (Robert C. Effros ed., 1994).

5. *Id.* Art. 18, Annex.

6. *See* Sydney J. Key & Hal S. Scott, *International Trade in Banking Services: A Conceptual Framework,* Occasional Papers 35, Group of Thirty (1991).

7. *See* Second Banking Directive, *supra* note 4, Art. 13.

8. Foreign Bank Supervision Enhancement Act, Subtitle A of Title II of the Federal Deposit Insurance Corporation Improvement Act, Public Law No. 102–242, 105 Stat. 2236 (1991), *reprinted in* 3 *Current Legal Issues Affecting Central Banks* 587 (Robert C. Effros ed., 1995).

9. Basle Committee on Banking Supervision, *Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments* (1992), *reprinted in* 3 *Current Legal Issues Affecting Central Banks, supra* note 8, at 301.

10. *Id.* at II.2.

11. Basle Committee on Banking Supervision, *Report on International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended in 1992, 1994, and 1995). The Basle Capital Accord is reprinted in 1 *Current Legal Issues Affecting Central Banks* 487 (Robert C. Effros ed., 1992). The 1992 amendment is reprinted in 3 *Current Legal Issues Affecting Central Banks, supra* note 8, at 296. Further amendments are reprinted herein as Appendix II(11).

12. The discussion of the Deposit-Guarantee Directive is based on the author's chapter *Deposit-Guarantee Directive,* in ***Banking and EC Law: Commentary*** (Martijn van Empel & René Smits eds., Supp. 3 August 1993). Council Directive 94/19 of 30 May 1994 on Deposit-Guarantee Schemes, 1994 O.J. (L 135) 5, is reprinted herein as Appendix III(1).

13. *Id.* Art. 4(1).

14. *Id.* Art. 7(4).

15. *Id.* Art. 4(2).

16. *Id.* Art. 4(3), Annex II.

17. *Id.* Art. 4(1).

18. Action brought on 18 August 1994 by the Federal Republic of Germany against (1) the European Parliament and (2) the Council of the European Union. Case C-233/94, 1994 O.J. (C 275) 20.

19. *Id.*

Chapter 8, "GATT and Its Effect on Banking Services" (O'Day)

1. General Agreement on Trade in Services, *in* The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations (December 15, 1993), *reprinted herein* as Appendix I(1).

2. *Id.* Art. XXIII.

3. *Id.* Art. II.

4. *Id.* Arts. XXVIII(a); *see also id.* Art. I(3).

5. *Id.* Art. II.

6. *Id.* Art. XVI.

7. *Id.* Art. XVII.

8. *Id.* Art. XX(1).

9. *Id.* Art. XX(2).

10. *Id.* Art. XXIII.

11. *Id.* Art. XXIV.

12. *See id.* Art. I(3)(b).

13. *Id.* Annex on Financial Services.

14. *Id.* Art. I(2), Annex on Financial Services, paragraph 1.1.

15. *Id.* Art. XVII.

16. *Id.* Annex on Financial Services, paragraph 1.2.

17. *Id.* Annex on Financial Services, paragraph 2.1.

18. *Id.*

19. *Id.* Annex on Financial Services, paragraph 3.

20. *See* 56 Federal Register 30036 (July 1, 1991) (codified in 17 C.F.R. Parts 200, 201, 210, 229, 230, 239, 240, 249, 260, and 269).

21. Understanding on Commitments in Financial Services (undated), *reprinted herein* as Appendix I(1a).

22. *Id.* paragraph 1.

23. *Id.*

24. *Id.* paragraphs 3, 4.

25. *Id.* paragraph 7.

26. *Id.* paragraph 8.

27. *See* The Fair Trade in Financial Services Act of 1995, H.R. 19, 104th Congress, 1st Session (1995).

Chapter 8, Comment (Muench)

1. General Agreement on Trade in Services, *in* The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations (December 15, 1993), *reprinted herein* as Appendix I(1).

2. *Id.* Annex on Financial Services, paragraph 2.1.

3. *Id.*

4. *Id.*

5. Understanding on Commitments in Financial Services (undated), *reprinted herein* as Appendix I(1a).

6. 19 U.S.C. § 2902(e) (1994).

7. *See* William Drozdiak, *Historic Trade Pact Signed, but Global Tensions Persist*, Washington Post, April 16, 1994.

Chapter 9, "The Implications of NAFTA for Central Banks" (Palzer)

1. North American Free Trade Agreement, December 8, 11, 14, and 17, 1992, Canada-Mexico-U.S. [hereinafter NAFTA], *reprinted in* 32 International Legal Materials 605 (1993). Selected provisions of NAFTA are reprinted herein as Appendix I(2).

For a description of how NAFTA will affect banks in the United States and Canada, *see* Karen MacAllister, *Note: NAFTA: How the Banks in the United States and Mexico Will Respond*, 17 Houston Journal of International Law 273 (1994).

2. Office of the United States Trade Representative, *Statement of Administrative Action: The North American Free Trade Agreement Act* 163–172 (1993).

3. *See* NAFTA, *supra* note 1, Art. 1416.

4. *Id.*

5. *Id.*

6. General Agreement on Trade in Services, *in* The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations (December 15, 1993), *reprinted herein* as Appendix I(1).

7. *See supra* Kathleen O'Day, *GATT and Its Effect on Banking Services* (Chapter 8).

8. NAFTA, *supra* note 1, Art. 1405.

9. *Id.* Art. 1404.

10. *Id.* Art. 1406.

11. *Id.* Art. 1407.

12. *Id.* Art. 1408.

13. *Id.* Art. 1405.

14. *Id.* Art. 1405(5).

15. *Id.* Art. 1404.

16. *Id.* Art. 1406.

17. *Id.* Art. 1407.

18. *Id.* Art. 1407(1).

19. *Id.* Art. 1408(2).

20. *Id.* Art. 1408.

21. *Id.* Art. 1408(2).

22. *Id.* Art. 1408(1).

23. *Id.* Art. 1411.

24. *Id.* Arts. 1109, 1401.

25. *Id.* Art. 1110.

26. *Id.* Art. 1411(1).

27. *Id.* Art. 1411(4).

28. *Id.* Arts. 1109, 1401.

29. *Id.* Art. 1110.

30. *Id.* Arts. 1115–38, 1401(2).

31. *Id.* Art. 1110(2).

32. *See id.* Art. 1409.

33. *Id.* Art. 1410.

34. *Id.* Art. 1410(1).

35. *Id.* Art. 1410(2).
36. *Id.* Art. 1410(1).
37. *Id.* Art. 1410(2).
38. *Id.* Art. 1410(4).
39. *Id.* Arts. 1401(3)(a), 1410(3).
40. *Id.* Chapter 11, Chapter 20, and Arts. 1412–15.
41. General Agreement on Trade in Services, *supra* note 6, Art. XXIII.
42. NAFTA, *supra* note 1, Arts. 1414, 2010(1).
43. *Id.* Art. 1414(4).
44. *Id.* Art. 2006.
45. *Id.* Art. 2007.
46. *Id.* Art. 2008.
47. *Id.* Art. 2019.
48. *Id.* Arts. 1109, 1110, 1401.
49. *See* The Bank Act, Statutes of Canada, Chapter B-1.01 (1993); Ley de Instituciones de Crédito, Diario Oficial de la Federación, July 18, 1990.
50. The Glass-Steagall Act is composed of sections 16, 20, 21, and 32 of the Banking Act of 1933 (Act of June 16, 1933, Chapter 89, 48 Stat. 162), codified at 12 U.S.C. §§ 24(Seventh), 78, and 377–378. The Bank Holding Company Act of 1956, 70 Stat. 133, is codified at 12 U.S.C. § 1841 *et seq.* (1994).
51. Under the Interstate Banking and Branching Efficiency Act, Public Law No. 103–328, 108 Stat. 2338 (1994), the Federal Reserve is authorized to approve an application by a bank holding company to acquire a bank in any state without regard to whether this is prohibited under state law. This authority is subject to certain limitations, including a concentration limit that restricts the percentage of deposits that a banking organization controls on a national and state basis.

The law also authorizes the federal banking authorities to approve mergers between banks with different home states without regard to whether this is prohibited under state law (subject to a state option described below). Certain restrictions on branching acquisitions and mergers apply. The law authorizes either the acquisition of a bank in another state or, if a state expressly permits, an acquisition of a single branch without the rest of the bank. States may opt out of interstate mergers before June 1, 1997 (although not in respect of distressed banks). In addition, the law permits federal regulators to authorize banks to open new branches across state lines if the receiving state permits this. *See generally* Murray A. Indick & Satish M. Kini, ***The Interstate Banking and Branching Efficiency Act: New Options, New Problems***, 112 Banking Law Journal 100 (1995).

52. Interstate Banking and Branching Efficiency Act, *supra* note 51; NAFTA, *supra* note 1, Art. 1403(3).
53. NAFTA, *supra* note 1, Art. 1404(4), Annex 1404.4.
54. *Id.* Annex VII, Schedule of Mexico, Section B.
55. *See id.*
56. *Id.* Annex 1413.6, Section B.
57. *Id.* Art. 2104.
58. International Monetary Fund, Articles of Agreement, Art. VIII, § 2(*a*) (April 1993) (providing "[s]ubject to the provisions of Article VII, Section 3(*b*) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions.").
59. *See id.* Art. VI, § 3 (providing "[m]embers may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(*b*) and in Article XIV, Section 2.").

60. NAFTA, *supra* note 1, Art. 2104.
61. *Id.* Art. 2104(5)(a), (6)(a).
62. *Id.* Art. 2104(5)(b).
63. *Id.* Art. 2104(3).
64. *Id.* Art. 2104(2)(a).
65. *Id.* Art. 2104(3)(d).
66. *Id.* Art. 2104(2)(b), (c).
67. *Id.* Art. 2104(5)(d).
68. Giuseppe Schiavone, *International Organizations: A Dictionary and Directory* 39 (3d ed. 1992).

> APEC has rapidly evolved from an "informal process" to the leading intergovernmental forum for economic cooperation in the Asia-Pacific region, currently including 15 nations as full members.

69. Tratado para la Constitucion de un Mercado Común entre la Republica Argentina, la Republica Federativa del Brasil, la Republica del Paraguay y la Republic Oriental del Uruguay [Treaty of Asuncíon], March 26, 1991, Argentina-Brazil-Paraguay-Uruguay, *reprinted in* 30 International Legal Materials 1041 (1991) (creating a common market known as MERCOSUR between Argentina, Brazil, Paraguay, and Uruguay).

Chapter 9, Comment (Kozolchyk)

1. North American Free Trade Agreement, December 8, 11, 14, and 17, 1992, Canada-Mexico-U.S. [hereinafter NAFTA], Art. 1405, *reprinted in* 32 International Legal Materials 605 (1993). Selected provisions of NAFTA are reprinted in Appendix I(2).
2. *Id.* Annex VII, Schedule of Mexico, Section A (providing "Measures: *Ley para Regular las Agrupaciones Financieras, Articulo 18 and Ley de Instituciones de Crédito, Articulos 11 and 15.* Description: Aggregate foreign investments in holding companies and in commercial banks are limited to 30 percent of common stock capital (*capital ordinario*). These percentage limits do not apply to investments in foreign financial affiliates as such term is defined in, and subject to terms and conditions under, sections B and C of this Schedule.")
3. *See* Ley de Instituciones de Crédito de 18 de Julio de 1990 as amended by Decreto de 15 de Febrero de 1995 (que reforma, adiciona y deroga diversas disposiciones de la Ley Para Regular Agrupaciones Financieras, de la Ley de Instituciones de Crédito y de la Ley de Mercado de Valores, Art. 17, paragraph VII (July 18, 1990)). Paragraph VII exempts foreign financial institutions and subsidiary holding companies from the prohibition of acquiring more than 5 percent of the shares of stock of any type issued by Mexican universal banks. Nevertheless, these acquisitions must be done in compliance with the programs approved by the Ministry of Finance and Public Credit, with the purpose of transforming the universal banking institution in question into a subsidiary of the foreign holding company. The upper limit of allowable acquisitions is set forth in subparagraph 2 of section VII; the total net acquisition cannot exceed 6 percent of the net aggregate value of all of the universal banking institutions in Mexico. This 6 percent limitation in effect prevents the acquisition of any of Mexico's three largest banks—Banamex, Bancomer, and Serfin.
4. *See* NAFTA, *supra* note 1, Annex VII, Schedule of Mexico, Sections A, B, C.

Chapter 10, "Banking Law Developments in Latin America" (Guardia)

1. *See* Hernán Felipe Errázuriz, *Legal Aspects of Economic Reform in Latin America: The Case of Chile*, 3 *Current Legal Issues Affecting Central Banks* 129 (Robert C. Effros ed., 1995).
2. Constitutional Organic Act of the Central Bank of Chile, Art. 3, Official Gazette Law No. 18,840 (March 10, 1990), as amended by Law No. 18,901 (January 6, 1990) and Law No. 18,970 (October 10, 1989).

3. Ley del Banco Central de la Republica Argentina, Law No. 193 of 1991, Art. 3 (November 6, 1991).

4. Ley Organica del Banco de la Republica, Law No. 31 of 1992, Art. 2 (December 29, 1992).

5. Carta Organica del Banco Central del Uruguay, Law No. 16.696, Art. 3 (March 1995).

6. *Id.* Art. 4.

7. Constitution of the Republic of Chile, Arts. 97, 98, ***reprinted in*** IV *Constitutions of the Countries of the World* (Albert P. Blaustein & Gisbert H. Flanz eds., 1994).

8. Constitutional Organic Act of the Central Bank of Chile, ***supra*** note 2, Art. 7.

9. *Id.*

10. *Id.* Art. 17.

11. Ley del Banco Central de la Republica Argentina, ***supra*** note 3, Art. 7.

12. *Id.* Art. 3.

13. *Id.* Art. 9.

14. Constitución Politica de los Estados Unidos Mexicanos [Constitution], Art. 28.

15. *Id.*

16. Constitutional Organic Act of the Central Bank of Chile, ***supra*** note 2, Art. 4; Ley del Banco Central de la Republica Argentina, ***supra*** note 3, Art. 10(i); Ley Organica del Banco de la Republica, ***supra*** note 4, Art. 5.

17. Constitutional Organic Act of the Central Bank of Chile, ***supra*** note 2, Art. 27.

18. Ley del Banco Central de la Republica Argentina, ***supra*** note 3, Art. 19.

19. *Id.* Art. 20.

20. Ley del Banco Central de Venezuela de 4 de diciembre 1992, Art. 55.

21. *Id.* Art. 54.

22. Constitutional Organic Act of the Central Bank of Chile, ***supra*** note 2, Art. 35.

23. Ley del Banco Central de la Republica Argentina, ***supra*** note 3, Art. 14(d).

24. Carta Organica del Banco Central del Uruguay, ***supra*** note 5, Art. 39.

25. Constitution of the Republic of Costa Rica, Art. 121, § 17, ***reprinted in*** IV *Constitutions of the Countries of the World* (Albert P. Blaustein & Gisbert H. Flanz eds., 1994).

26. Ley del Banco Central de Venezuela, ***supra*** note 20, Art. 92.

27. Ley del Banco Central de la Republica Argentina, ***supra*** note 3, Art. 29.

28. The Ley de Convertibilidad del Austral [Law on the Convertibility of the Austral], Law No. 23, 928 of March 27, 1991 (published March 28, 1991), provides, in part:

> *Article 1.* The austral is hereby declared convertible with the U.S. dollar effective April 1, 1991, at a selling rate of australs ten thousand (A 10,000) per dollar, under the terms established in this law.
>
> *Article 2.* The Central Bank of the Argentine Republic shall sell foreign exchange upon request for conversion transactions at the rate stipulated in the preceding article, and it shall withdraw from circulation those australs received in exchange.
>
> *Article 3.* The Central Bank of the Argentine Republic may buy foreign exchange at market prices with its own resources, on behalf and by order of the National Government, or by issuing the australs needed for this purpose.
>
> *Article 4.* The freely usable reserves of the Central Bank of the Argentine Republic in gold and foreign currencies shall at all times be equivalent to at least one hundred percent (100%) of the monetary base. When reserves are invested in deposits, other interest-bearing operations, or in domestic or foreign government securities payable in gold, precious metals, U.S. dollars, or other similarly sound currencies, such reserves shall be computed at market value for purposes of this law.

Article 5. The Central Bank of the Argentine Republic shall make the necessary changes to its balance sheet and accounting statements to reflect the amount, composition, and investment of the freely usable reserves, on the one hand, and the amount and composition of the monetary base, on the other hand.

Article 6. The assets making up the reserves mentioned in the preceding article shall constitute common backing (prenda común) for the monetary base, shall be unattachable, and may not be used for purposes other than those prescribed in this law. The monetary base in australs shall consist of currency in circulation plus financial institutions' demand deposits with the Central Bank of the Argentine Republic in current or special accounts.

29. Constitutional Organic Act of the Central Bank of Chile, *supra* note 2, Art. 39.

30. *Id.* Arts. 39–52.

31. Ley de Instituciones de Credito, Arts. 1, 49, Diario Oficial de la Federación (July 18, 1990).

Chapter **10**, Comment (Feldman)

1. *See* Maxwell J. Fry, *The Fiscal Abuse of Central Banks*, International Monetary Fund Working Paper WP/93/58 (July 1993).

2. *See* Ernesto V. Feldman, *Issues in Monetary Policy and Banking Regulation* (1994).

3. *See* Carl-Johan Lindgren & Daniel E. Dueñas, *Strengthening Central Banks' Independence in Latin America* (1994).

Chapter **11A**, "Report from the Board of Governors of the Federal Reserve System: Establishing Foreign Bank Offices in the United States" (Mattingly)

1. Foreign Bank Supervision Enhancement Act, Subtitle A of Title II of the Federal Deposit Insurance Corporation Improvement Act, Public Law No. 102–242, §§ 201–215, 105 Stat. 2236, 2286–305 (1991) [hereinafter FBSEA], *reprinted in* 3 *Current Legal Issues Affecting Central Banks* 587 (Robert C. Effros ed., 1995); *see* Deborah Burand, *Regulation of Foreign Banks' Entry Into the United States under the FBSEA: Implementation and Implications,* 24 Law & Policy in International Business 1089 (1993); Robert C. Effros, *Comments on "Regulation of Foreign Banks' Entry into the United States under the FBSEA: Implementation and Implications," A Paper Presented by Deborah Burand,* 24 Law & Policy in International Business 1125 (1993).

2. FBSEA, *supra* note 1.

3. House Report No. 102–330, 102d Congress, 1st Session, 105 (1991).

4. International Banking Act § 4(a), 12 U.S.C. § 3102(b) (1978).

5. FBSEA, *supra* note 1, §§ 202–204.

6. *Id.* § 203(a)(1).

7. 58 Federal Register 6348 (1993) (codified at 12 Code of Federal Regulations parts 211, 225, 263, 265).

8. *Id.* at 6358 (noting the interim rule was published at 57 Federal Register 12992 (1992)).

9. *Id.* at 6362 (amending 12 Code of Federal Regulations §§ 211.26 and 211.28).

10. *Id.* at 6359–61 (amending 12 Code of Federal Regulations § 211.24).

11. *Id.* at 6348.

12. 61 Federal Register 2899 (1996) (to be codified at 12 Code of Federal Regulations part 211).

13. Board of Governors of the Federal Reserve System & Secretary of the Department of the Treasury, *Capital Equivalency Report* (June 19, 1992); *see also* Peter J. Wallison, *The Decline of National Treatment in U.S. Financial Services Trade Policy, in* 3 *Current Legal Issues Affecting Central Banks, supra* note 1, at 175.

14. Basle Committee on Banking Supervision, ***International Convergence of Capital Measurement and Capital Standards*** (July 1988, as amended in 1992, 1994, and 1995). The Basle Capital Accord is ***reprinted in*** 1 ***Current Legal Issues Affecting Central Banks*** 487 (Robert C. Effros ed., 1992). The 1992 amendment is ***reprinted in*** 3 ***Current Legal Issues Affecting Central Banks*** 296 (Robert C. Effros ed., 1995). The 1994 and 1995 amendments are reprinted herein as Appendix II(11).

15. U.S. Department of the Treasury & Board of Governors of the Federal Reserve System, ***Subsidiary Requirement Study*** (undated).

16. 58 Federal Register 513 (1993).

17. 58 Federal Register 11992 (1993) (final rule at 59 Federal Register 60703 (1994) (codified at 12 Code of Federal Regulations part 346)).

18. 59 Federal Register 55026 (1994)(amending 12 Code of Federal Regulations part 211).

19. ***Announcements-New Procedures For Processing Applications Filed By Foreign Banks***, 79 Federal Reserve Bulletin No. 5, at 477 (May 1993).

20. ***Id.***

21. FBSEA, ***supra*** note 1, § 202(a).

22. ***Id.***

23. ***Id.***

24. ***Id.***

25. 59 Federal Register 64171 (1994).

26. ***Id.***

27. ***Id.***

28. ***See*** John Moscow, ***The Anatomy of an International Banking Scandal, in*** 3 ***Current Legal Issues Affecting Central Banks, supra*** note 1, at 257; William Ryback, ***The Work of the Basle Committee, in*** 3 ***Current Legal Issues Affecting Central Banks, supra***, at 263.

29. FBSEA, ***supra*** note 1, § 203(a).

Chapter 11B, "Report from the Federal Deposit Insurance Corporation: National Deposit Insurance Has Worked to Promote Banking Stability" (Rose, Bradley, and Stamp)

1. This paper was presented on May 13, 1994 by Thomas A. Rose; only his biography appears in the biographical sketches.

2. Federal Deposit Insurance Corporation, ***Annual Report*** 4 (1992); FDIC, ***The First Fifty Years*** 4 (1984).

3. The OCC was formed as a bureau within the Department of the Treasury in 1864. 12 U.S.C. § 1 (1994).

4. The Office of Thrift Supervision was formed in 1989 when the Federal Home Loan Bank Board and Federal Savings and Loan Insurance Corporation were abolished. The Resolution Trust Corporation was also formed at that time to resolve the crisis in the savings and loan institutions and is scheduled to transfer its operations back to the FDIC on December 31, 1995.

5. Congress passed the Federal Reserve Act in 1913 to create the Federal Reserve System in response to the panic of 1907. The Federal Reserve's powers were greatly expanded during the 1930s in response to the Great Depression.

6. The FDIC was created as a part of the Banking Act of 1933. 12 U.S.C. § 1811 (1994).

7. ***See, e.g.***, The Need for Major Consolidation and Overhaul of the Bank Regulatory Agencies into a New and Independent Banking Structure: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 103d Congress, 2d Session (1994).

8. ***The First Fifty Years, supra*** note 2, at 3–4.

9. 12 U.S.C. § 1811 (1994).

10. Economic Recovery Tax Act of 1981, Public Law No. 97–34, 95 Stat. 552 (codified as amended at 26 U.S.C.)

11. Tax Reform Act of 1986, Public Law No. 99–509, 100 Stat. 1951 (codified as amended in scattered sections of 26 U.S.C.).

12. Depository Institutions Deregulation and Monetary Control Act of 1980, Public Law No. 96–221, 94 Stat. 142–145 (1980).

13. Garn-St. Germain Depository Institutions Act of 1982, Public Law No. 97–320, 96 Stat. 1469 (1982).

14. Competitive Equality in Banking Act of 1987, Public Law No. 100–86, 101 Stat. 552 (1987).

15. FDIC, *Annual Report* 168 (1993).

16. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Public Law No. 101–73, 103 Stat. 183 (1989).

17. 12 U.S.C. § 1815(e) (1994).

18. Federal Deposit Insurance Corporation Improvement Act of 1991, Public Law No. 102–242, 105 Stat. 2236 (1991).

19. *Id.*

20. Omnibus Budget Reconciliation Act of 1993, Public Law No. 103–66, § 3001, 107 Stat. 31 (1993). Section 3001(a) provides:

> (a) In General—Section 11(d)(11) of the Federal Deposit Insurance Act (12 U.S.C. § 1821(d)(11)) is amended to read as follows:
>
> "(11) Depositor preference.
>
> (A) In general. Subject to section 5(e)(2)(C), amounts realized from the liquidation or other resolution of any insured depository institution by any receiver appointed for such institution shall be distributed to pay claims (other than secured claims to the extent of any such security) in the following order of priority:
>
> (i) Administrative expenses of the receiver.
>
> (ii) Any deposit liability of the institution.
>
> (iii) Any other general or senior liability of the institution (which is not a liability described in clause (iv) or(v)).
>
> (iv) Any obligation subordinated to depositors or general creditors (which is not an obligation described in clause (v)).
>
> (v) Any obligation to shareholders or members arising as a result of their status as shareholders or members (including any depository institution holding company or any shareholder or creditor of such company).
>
> (B) Effect on state law.
>
> (i) In general. The provisions of subparagraph (A) shall not supersede the law of any State except to the extent such law is inconsistent with the provisions of such subparagraph, and then only to the extent of the inconsistency.
>
> (ii) Procedure for determination of inconsistency. Upon the Corporation's own motion or upon the request of any person with a claim described in subparagraph (A) or any State which is submitted to the Corporation in accordance with procedures which the Corporation shall prescribe, the Corporation shall determine whether any provision of the law of any State is inconsistent with any provision of subparagraph (A) and the extent of any such inconsistency.
>
> (iii) Judicial review. The final determination of the Corporation under clause (ii) shall be subject to judicial review under chapter 7 of title 5, United States Code.

(C) Accounting report. Any distribution by the Corporation in connection with any claim described in subparagraph (A)(v) shall be accompanied by the accounting report required under paragraph (15)(B)."

21. Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, *supra* note 16, commercial bank deposits are insured by the Bank Insurance Fund (BIF). Savings and loan deposits are insured by the Savings Association Insurance Fund (SAIF). Both the BIF and the SAIF are administered by the FDIC.

Chapter 11C, "Report from the Office of the Comptroller of the Currency: The Future of Bank Supervision" (Bettauer)

1. Since this presentation was given in 1994, the OCC has further developed its supervisory policies for risk management by national banks. In December 1995, the OCC issued a booklet entitled *Large Bank Supervision* to provide guidance to examiners of national banks with total assets of $1 billion or more and to their national bank affiliates. The guidance outlines the OCC's system of measuring and evaluating nine categories of risk inherent in banking activities: credit, interest rate, liquidity, price, foreign exchange, transaction, compliance, strategic, and reputation risks. As of Febuary 1996, a similar, less-structured system was being prepared to address risk management at community banks.

2. In 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act was enacted. Public Law No. 103–328, 108 Stat. 2338 (1994). It amended section 3(d) of the Bank Holding Company Act and other statutory provisions and provides for interstate banking and branching, subject to certain conditions. *Id.* § 101 *et seq.* Until recently, pursuant to the McFadden Act, national banks were only permitted to branch intrastate to the extent that state banks were authorized by statute to open branch offices. Chapter 191, § 7, 44 Stat. 1228 (1927); Chapter 89, § 23, 48 Stat. 189, 190 (1933). Section 102 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, *supra,* amended the McFadden Act and provides for interstate banking and branching by national banks, subject to certain conditions.

Chapter 11D, "Report from the Office of Thrift Supervision" (Buck)

1. David H. Enzel assisted Ms. Buck in the preparation of this chapter.
2. *General Enforcement Policy,* OTS Regulatory Bulletin 18–1b, at 1 (April 18, 1994).
3. 12 Code of Federal Regulations part 563b (1995).
4. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Public Law No. 101–73, 103 Stat. 183 (1989).
5. The Federal Deposit Insurance Corporation Improvement Act of 1991, Public Law No. 102–242, 105 Stat. 2236 (1991).
6. *General Enforcement Policy, supra* note 2, at 1.
7. *See supra* note 3.
8. 39 Federal Register 9142 (1974).
9. *See, e.g.,* 51 Federal Register 40127 (1986); 47 Federal Register 19672 (1982).
10. Senate Bill 1801, 103d Congress, 2d Session (1994).
11. *See supra* note 3.
12. 59 Federal Register 22725 (1994)(interim final rule amending 12 Code of Federal Regulations part 563b); *see also* 59 Federal Register 61247 (1994) (final rule).
13. 59 Federal Register at 22733–34 (1994) (amending 12 Code of Federal Regulations § 563b.3(g)(4)).
14. *Id.*
15. *Id.* at 22733 (amending 12 Code of Federal Regulations § 563b.3(c)(6)).
16. *Id.*
17. *Id.* at 22732 (amending 12 Code of Federal Regulations § 563b.2(a)(19)).

18. *Id.* at 22735 (amending 12 Code of Federal Regulations § 563b.5(d)(4)).

19. *Id.* at 22735 (amending 12 Code of Federal Regulations § 563b.7(f)(ii)).

20. *Id.* at 22725 (amending 12 Code of Federal Regulations § 563b.10).

21. OTS, ***Moratorium on Merger Conversions of Thrifts is Declared by OTS*** (Press Release, January 31, 1994).

22. 59 Federal Register 22764 (1994) (proposed May 3, 1994); ***see also*** 59 Federal Register 61247 (1994) (final rule dated November 30, 1994).

23. Community Reinvestment Act of 1977, Public Law No. 95–128, Title VIII, 91 Stat. 1147 (1997).

24. ***See supra*** note 22.

25. 12 Code of Federal Regulations § 563e.7 (1995).

26. Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision, ***Interagency Statement on Retail Sales of Nondeposit Investment Products*** (Feb. 15, 1994), ***reprinted in*** OCC, ***Handbook for National Bank Examiners*** (Temporary Insert, February 24, 1994).

27. ***Id.***

28. ***Id.***

29. ***Id.***

30. 15 U.S.C. §§ 78c(a)(4)-(5), 78o(a), 78o(b)(8) (1994).

31. Investment Advisors Act of 1940, Chapter 686, Title II, 54 Stat. 847 (current version at 15 U.S.C. §§ 80b-1 *et seq.*).

Chapters **11A–D**, Comment (Baerst)

1. ***See*** Jerry Knight, ***Bentsen Backs Single Bank Agency; Move to Streamline Regulation Draws Federal Reserve Opposition,*** The Washington Post, November 24, 1993, at D1; ***Treasury Secretary Outlines Banking-Agency Consolidation; the Clinton Administration Has Proposed a Merger to Create a Single Commission***, The Orlando Sentinel, November 24, 1993, at C1; ***see generally*** Claudia Cummins, ***Fed Girding to Fight Plan for a Single Bank Regulator,*** The American Banker, December 20, 1993, at 1; Robert M. Garsson, ***Rep. Leach Assails Plan to Merge the Regulators,*** The American Banker, December 17, 1993, at 3; ***see also*** Regulatory Consolidation Act of 1994, S. 1985, 103d Congress, 2d Session (1994); ***see*** Bank Regulatory Consolidation and Reform Act of 1995, H.R. 17, 104th Congress, 1st Session (1995); Regulatory Consolidation Act of 1994, S. 1985, 103d Congress, 2d Session (1994); Regulatory Consolidation Act of 1993, H.R. 1214, 103d Congress, 1st Session (1993).

2. William J. McDonough, ***Rethinking the Structure and Regulation of Financial Services, in*** Federal Reserve Bank of New York, ***Annual Report 1993,*** at 9.

3. ***Id.***

4. Remarks by William M. Isaac, former chairman of the Federal Deposit Insurance Corporation, at a banking law conference held at The Carlton Hotel, Washington, D.C., May 12, 1994; ***see also*** William M. Isaac, ***Comment: Banks May Be Giving Up the War If They Don't Win Insurance Battle,*** The American Banker, January 13, 1994 at 22.

5. ***See herein Who Should Be the Banking Supervisors?*** (Chapters 18A-D); ***see also*** 3 ***Current Legal Issues Affecting Central Banks*** Introduction and Chapters 15A–C (Robert C. Effros ed., 1995).

6. Treaty on European Union, February 7, 1992, Official Journal of the European Communities [O.J.] (C 224) 1.

7. 26 U.S.C. § 401(k) (1994).

8. U.S. Department of the Treasury & Board of Governors of the Federal Reserve System, ***Subsidiary Requirement Study*** (undated); ***see*** Peter J. Wallison, ***The Decline of National Treatment in U.S. Financial Services Trade Policy, in*** 3 ***Current Legal Issues Affecting Central Banks, supra*** note 5, at 175.

9. Senate Bill 1963, 103d Congress, 2d Session (1994) was incorporated into the House Bill 3841, 103d Congress, 2d Session (1994), which became the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Public Law No. 103–328, 108 Stat. 2338 (1994).

The Riegle-Neal Interstate Banking and Branching Efficiency Act, *supra,* amended the International Banking Act of 1978 (12 U.S.C. § 3103(a)) to provide that a foreign bank may establish a branch, agency, subsidiary bank, or subsidiary commercial lending company in a home state of the United States. *Id.* § 104. It may then establish branches or agencies in other states. *Id.* However, if the Federal Reserve Board or the Office of the Comptroller of the Currency finds that the capital requirements of the foreign bank can be verified only if its banking activities in the United States are carried out in a domestic banking subsidiary in the United States, the Board or the Comptroller, as the case may be, may require the foreign bank to establish a domestic banking subsidiary in the United States. *Id.*

10. Second Council Directive 89/646 of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 O.J. (L 386) 1, as corrected 1990 O. J. (L 83) 128 and 1990 O. J. (L 158) 87, *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 251 (Robert C. Effros ed., 1994).

Chapter **12**, "Banking Reform in the United States" (Marks)

1. Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Public Law No. 103–328, 108 Stat. 2338 (1994) [hereinafter IBBA].

2. Fair Trade in Financial Services Act of 1995, H.R. 19, 104th Congress, 1st Session (1995); National Treatment in Banking Act of 1994, H.R. 4926, 103d Congress, 2d Session (1994); *see* Fair Trade in Financial Services Act of 1990, S. 2028 and H.R. 697, 101st Congress, 2d Session (1990); *see also* Fair Trade in Financial Services Act of 1993, H.R. 3248 and H.R. 3565, 103d Congress, 1st Session (1993); *see herein* Kathleen O'Day, *The GATT and Its Effect on Banking Services* (Chapter 8).

3. National Treatment in Banking Act of 1994, H.R. 4926, 103d Congress, 2d Session (1994).

4. General Agreement on Trade in Services, *in* The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations (December 15, 1993), *reprinted herein as* Appendix I(1).

5. Robert M. Garsson, *Bank Branching Wins Administration Backing,* The American Banker, October 26, 1993, at 1.

6. IBBA, *supra* note 1.

7. *See generally* Murray A. Indick & Satish M. Kini, *The Interstate Banking and Branching Efficiency Act: New Options, New Problems,* 112 Banking Law Journal 100 (1995).

8. Second Council Directive 89/646 of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 Official Journal of the European Communities [O.J.] (L 386) 1, as corrected 1990 O.J. (L 83) 128 and 1990 O.J. (L 158) 87, *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 251 (Robert C. Effros ed., 1994).

9. *See* Jerry Knight, *Bentsen Backs Single Bank Agency; Move to Streamline Regulation Draws Federal Reserve Opposition,* The Washington Post, November 24, 1993, at D1; *Treasury Secretary Outlines Banking-Agency Consolidation; the Clinton Administration Has Proposed a Merger to Create a Single Commission,* The Orlando Sentinel, November 24, 1993, at C1; *see generally* Claudia Cummins, *Fed Girding to Fight Plan for a Single Bank Regulator,* The American Banker, December 20, 1993, at 1; Robert M. Garsson, *Rep. Leach Assails Plan to Merge the Regulators,* The American Banker, December 17, 1993, at 3; *see*

also The Bank Regulatory Consolidation and Reform Act of 1995, H.R. 17, 104th Congress, 1st Session (1995); Regulatory Consolidation Act of 1994, S. 1985, 103d Congress, 2d Session (1994); Regulatory Consolidation Act of 1993, H.R. 1214, 103d Congress, 1st Session (1993).

10. 12 U.S.C. § 1813(q) (1994). The FDIC also has backup enforcement authority to stop unsafe practices at any FDIC-insured institution if the institution's primary federal regulator fails to do so.

11. Staff Report of the House Subcommittee on Domestic Finance of the House Committee on Banking and Currency, 93d Congress, 1st Session, *Financial Institutions: Reform and the Public Interest* 5 (Committee Print 1973).

12. *See supra* note 9.

13. *See* Carter H. Golembe, *Federal Banking Agency Reform: The Central Bank Connection,* 12 Banking Policy Report No. 24, December 20, 1993, at 4 (quoting Mr. Robertson and citing the Annual Convention of the Tennessee Bankers Association, May 16, 1962, *reprinted in Hearings on the Federal Bank Commission Act of 1977* at 500).

14. *Statement by John P. LaWare, Chairman, Federal Financial Institutions Examination Council and Member, Board of Governors of the Federal Reserve System, Before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, February 13, 1993,* 79 Federal Reserve Bulletin No. 4, at 281, 283 (April 1993).

15. *Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, U.S. House of Representatives, May 25, 1994,* 80 Federal Reserve Bulletin No. 7, at 594, 596 (July 1994).

16. *Id.*

17. *Statement by Susan M. Phillips, Member, Board of Governors of the Federal Reserve System, Before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, October 28, 1993,* 79 Federal Reserve Bulletin No. 12, at 1137, 1140 (December 1993).

18. Public Law No. 102–546, 106 Stat. 3590 (1992)(codified in scattered sections of 7 U.S.C.).

19. 7 U.S.C. § 1 *et seq.* (1994).

20. Futures Trading Practices Act of 1992, *supra* note 18, § 502.

21. 57 Federal Register 53627 (November 12, 1992)(final rule published as 58 Federal Register 5587 (January 22, 1993)(current version at 17 Code of Federal Regulations part 35)).

22. Federal Deposit Insurance Corporation Improvement Act of 1991, Title IV, Subtitle A, Public Law No. 102–242, 105 Stat. 2236 (1991); Bankruptcy: Swap Agreements and Forward Contracts, Public Law No. 101–311, 104 Stat. 267 (1990)(amending various sections of the Bankruptcy Code, including 11 U.S.C. § 546, and inserting 11 U.S.C. § 560).

23. 59 Federal Register 4780 (1994) (current version at 12 Code of Federal Regulations part 231).

24. Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 119 (Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments)* (October 1994).

25. The Derivatives Safety and Soundness Supervision Act of 1995, H.R. 31, 104th Congress, 1st Session (1995); The Risk Management Improvement and Derivatives Oversight Act of 1995, H.R. 20, 104th Congress, 1st Session (1995); The Derivatives Dealers Act of 1995, H.R. 1063, 104th Congress, 1st Session (1995).

26. U.S. General Accounting Office, *Financial Derivatives: Actions Needed to Protect the Financial System*, GAO/GGD-94–133 (May 1994).

27. Minority Staff, House Banking Committee, *Risks Involved in Bank Derivatives Activities* (October 28, 1993).

Chapter 12, Comment (Bradfield)

1. *See* Fair Trade in Financial Services Act of 1990, S. 2028 and H.R. 697, 101st Congress, 2d Session (1990); Fair Trade in Financial Services Act of 1993, H.R. 3248 and H.R. 3565, 103d Congress, 1st Session (1993); National Treatment in Banking Act of 1994, H.R. 4926, 103d Congress, 2d Session (1994); Fair Trade in Financial Services Act of 1995, H.R. 19, 104th Congress, 1st Session (1995).
2. *See* Claudia Cummins, *LaWare Says Congress, Clinton Impede U.S. Banks Globally,* The American Banker, March 8, 1994, at 2 (quoting Governor LaWare).
3. The Riegle-Neal Interstate Banking and Branching Efficiency Act, Public Law No. 103-328, 108 Stat. 2338 (1994).
4. The Glass-Steagall Act of 1933 is composed of sections 16, 20, 21, and 32 of the Banking Act of 1933 (Act of June 16, 1933, Chapter 89, 48 Stat. 162), codified at 12 U.S.C. §§ 24 (Seventh), 78, 377–78 (1933).
5. The Federal Deposit Insurance Corporation Improvement Act of 1991, Public Law No. 102-242, 105 Stat. 2236 (1991).
6. *See* Jerry Knight, *Bentsen Backs Single Bank Agency; Move to Streamline Regulation Draws Federal Reserve Opposition,* The Washington Post, November 24, 1993, at D1; *Treasury Secretary Outlines Banking-Agency Consolidation; the Clinton Administration Has Proposed a Merger to Create a Single Commission*, The Orlando Sentinel, November 24, 1993, at C1; *see generally* Claudia Cummins, *Fed Girding to Fight Plan for a Single Bank Regulator,* The American Banker, December 20, 1993, at 1; Robert M. Garsson, *Rep. Leach Assails Plan to Merge the Regulators,* The American Banker, December 17, 1993, at 3; *see also* The Bank Regulatory Consolidation and Reform Act of 1995, H.R. 17, 104th Congress, 1st Session (1995); Regulatory Consolidation Act of 1994, S. 1985, 103d Congress, 2d Session (1994); Regulatory Consolidation Act of 1993, H.R. 1214, 103d Congress, 1st Session (1993).
7. Loi no. 93.980 du 4 août 1993 relative au statut de la Banque de France et à l'activité et au contrôle des établissements de crédit modifiée par la loi no. 93.1444 du 31 décembre 1993, Journal Officiel 11047 (August 6, 1993).
8. Ley del Banco Central de la Republica Argentina, Art. 3, No. 193 of 1991 (November 6, 1991); Ley del Banco de México, Art. 1, Diario Oficial Section 2, at 1 (December 23, 1993); *see* Decreto por el que se reforman los artículos 28, 73, y 123 de la Constitución Política de los Estados Unidos Mexicanos, Diario Oficial 2 (August 20, 1993); Iniciativa Presidencial de Reforma Constitucional Enviada al Congreso de la Unión por el Presidente Carlos Salinas de Gortari el 2 de mayo de 1900, Diario Oficial (June 27, 1990).
9. *See herein* Jacques Milleret, *French Banking Supervision* (Chapter 18D).
10. *See supra* note 3.

Chapter 13, "Banking Law Developments in the United Kingdom" (Blair)

1. Banking Act, 1987, Chapter 22.
2. Bank of England, *Banking Act Report for 1992–93.*
3. Bank of England Act, 1946, 9 & 10 George 6, Chapter 27, § 4(3).
4. Banking Act, 1979, Chapter 37.
5. *See* Banking Act, 1987, *supra* note 1.
6. *See* Command Paper No. 9695, at paragraph 4.7(1995)(Banking Supervision).
7. *See Deposit Protection Board v. Dalia*, 2 Appeal Cases [App. Cas.] 367 (1994)(concerning the rights of assignees of a deposit).
8. *See* Pete Cresswell, William Blair, Gregory Hill & Philip Wood, *Encyclopaedia of Banking Law* paragraph A(57) (updated looseleaf).

9. The Leigh-Pemberton Committee (set up following the Johnson Matthey Bankers affair) regarded concentrations of lending to individual borrowers or economic sectors as being the most important recent cause of difficulties in banks. Command Paper No. 9550, Chapter 5 (June 1985).

10. The Glass-Steagall Act of 1933 is composed of sections 16, 20, 21, and 32 of the Banking Act of 1933 (Act of June 16, 1933, Chapter 89, 48 Stat. 162), codified at 12 U.S.C. §§ 24 (Seventh), 78, 377–78 (1933).

11. Financial Services Act, 1986, Chapter 60, Schedule 1.

12. *See generally* William Blair, Austin Allison, Keith Palmer, & Peter Richards-Carpenter, *Banking and the Financial Services Act* Chapter 1 (1993).

13. *See supra* note 11.

14. Financial Services Act, 1986, *supra* note 11, § 43.

15. The latest version of the London Code of Conduct, *reprinted herein as* Appendix II(13), was issued on May 29, 1992.

16. The term "European Union" has been in use since the beginning of 1994, although the term "European Community" continues to be widely used where appropriate.

17. Council Directive 89/299 of 17 April 1989 on the Own Funds of Credit Institutions, 1989 Official Journal of the European Communities [O.J.] (L 124) 16, as amended by Directive 91/633 of 3 December 1991, 1991 O.J. (L 339) 33, and Directive 92/16 of 16 March 1992, 1992 O.J. (L 75) 48, *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 287 (Robert C. Effros ed., 1994).

18. Council Directive 89/647 of 18 December 1989 on a Solvency Ratio for Credit Institutions (as amended by Directive 91/31 of 19 December 1990), 1989 O.J. (L 386) 14, *reprinted in* 2 *Current Legal Issues Affecting Central Banks*, *supra* note 17, at 297.

19. Council Directive 92/30 of 6 April 1992 on the Supervision of Credit Institutions on a Consolidated Basis, 1992 O.J. (L 280) 54 (as amended), *reprinted in* 3 *Current Legal Issues Affecting Central Banks* 431 (Robert C. Effros ed., 1995).

20. Council Directive 92/121 of 21 December 1992 on the Monitoring and Control of Large Exposures of Credit Institutions, 1993 O.J. (L 29) 1, *reprinted in* 3 *Current Legal Issues Affecting Central Banks*, *supra* note 19, at 444.

21. Council Directive 94/19 of 30 May 1994 on Deposit-Guarantee Schemes, 1994 O.J. (L 135) 5, *reprinted herein as* Appendix III(1).

22. *Id.*

23. A "credit institution" is defined in the First Banking Directive as "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account." Council Directive 77/780 of 12 December 1977 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, Art. 1, 1977 O.J. (L 322) 30, *reprinted in* 2 *Current Legal Issues Affecting Central Banks*, *supra* note 17, at 251. In the United Kingdom, this term includes both banks and building societies.

24. Second Council Directive 89/646 of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions amending Directive 77/780/EEC (as corrected), 1989 O.J. (L 386) 1, and as corrected 1990 O.J. (L 83) 128 and 1990 O.J. (L 158) 87 [hereinafter Second Banking Directive], *reprinted in* 2 *Current Legal Issues Affecting Central Banks*, *supra* note 17, at 264.

25. Second Banking Directive, *supra* note 24, Annex.

26. Statutory Instruments 1992, No. 3218 (December 16, 1992).

27. *See* paragraph 2.3 of the Statement of Principles issued under The Banking Coordination (Second Council Directive) Regulations, 1992, Schedule 3, paragraph 5.

28. *Id.* paragraph 2.4.

29. Second Banking Directive, *supra* note 24, eighth recital.

30. Council Directive 93/22 of 10 May 1993 on Investment Services in the Securities Field, 1993 O.J. (L 141) 27, *reprinted in* 3 *Current Legal Issues Affecting Central Banks, supra* note 19, at 458.

31. The U.K. implementing provisions are the Investment Services Regulations, 1995, Statutory Instruments 1995, No. 3275.

32. Investment Services Directive, *supra* note 30, Annex.

33. *Inquiry into the Supervision of the Bank of Credit and Commerce International* (The Right Honourable Lord Justice Bingham, chairman, October 22, 1992).

34. *Id.* at 188–189.

35. Statutory Instruments 1994, No. 524.

36. Statutory Instruments 1994, Nos. 525, 526.

37. *Hazell v. Hammersmith and Fulham London Borough Council*, 2 App. Cas. 1 (House of Lords 1992).

38. Local Government Act, 1972, Chapter 70.

39. *Westdeutsche Landesbank Girozentrale v. Islington London Borough Council*, [1994] 1 Weekly Law Reports [W.L.R.] 938.

40. The Local Government (Scotland) Act, 1975, Chapter 30.

41. *Morgan Guaranty Trust Co. v. Lothian Regional Council*, The Times, November 30, 1993.

42. P.R. Wood, *English and International Set-Off* vii (1989).

43. *Re European Bank, Agra Bank Claim*, 8 Law Reports—Chancery Appeals Cases 41 (1872); *Garnett v. M'Kewan* [1872] 8 Law Reports—Exchequer Cases 10; *Halesowen Presswork v. Westminster Bank,* 1 Queen's Bench [Q.B.] 1, 34 (1971), *reversed on other grounds,* App. Cas. 785 (1972).

44. Insolvency Act, 1986, Chapter 45, § 323 (individual bankrupts); Insolvency Rules, 1986, Statutory Instruments 1986, No. 1925, Rule 4.90 (insolvent companies).

45. Companies Act, 1989, Chapter 40, Part VII.

46. *MS Fashions Ltd. v. BCCI,* Chancery Division 425 (Court of Appeal 1993).

47. *In Re Bank of Credit & Commerce International SA (No. 8)*, 3 All England Law Reports [All E.R.] 565 (1994).

48. *Re Charge Card Services Ltd.*, Chancery Division 150, 175 (1987).

49. *Welsh Development Agency v. Export Finance Co. Ltd.*, Butterworth's Company Law Cases [B.C.L.C.] 936, 953 (1991), B.C.L.C. 148, 166 (1992). *But see Morn's v. Agrichemicals Ltd.*, unreported, December 20, 1995.

50. *See generally* Bank of England, *Notice to Institutions Authorized under the Banking Act 1987 On Balance Sheet Netting and Cash Collateral*, BSD/1993/3.

51. United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, December 20, 1988, U.N. Doc. E/CONF.82/15 of December 19, 1988, *reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 17, at 375.

52. Bank Secrecy Act, Public Law No. 91–508, Titles I and II, 84 Stat. 1114 (1970) (current version at 12 U.S.C. §§ 1730d, 1829b, 1951–1959 and other scattered sections (1994)).

53. Council Directive 91/308 of 10 June 1991 on Prevention of the Use of the Financial System for the Purpose of Money Laundering, 1991 O.J. (L 166) 77, *reprinted in* 3 *Current Legal Issues Affecting Central Banks, supra* note 19, at 420.

54. Basle Committee on Banking Regulations and Supervisory Practices, *Statement on the Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering* (December 1988), *reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 17, at 327.

55. *Id.* Statement of Principles, paragraph V.

56. Drug Trafficking Offenses Act, 1986, Chapter 32; Criminal Justice (Scotland) Act, 1987, Chapter 41; Criminal Justice Act, 1988, Chapter 33; Prevention of Terrorism (Temporary Provisions) Act, 1989, Chapter 4; Criminal Justice (International Co-Operation) Act, 1990, Chapter 5; Northern Ireland (Emergency Provisions) Act, 1991, Chapter 24.

57. Criminal Justice Act, 1993, Chapter 36.

58. Money-Laundering Regulations, 1993, Statutory Instruments 1993, No. 1933.

59. Criminal Justice Act, 1993, *supra* note 57, § 18. There is an exception in relation to professional legal advisers.

60. Money-Laundering Regulations, *supra* note 58, paragraph 5(1).

61. The levels vary. One-off transactions beneath ECU 15,000, which is roughly equivalent to £ 19,538, are excluded for certain purposes.

62. Money-Laundering Regulations, 1993, *supra* note 58, paragraph 16(1).

63. Bank of England, *Statement of Principles, Banking Act 1987* § 16 paragraph 2.38.

64. *Tournier v. National Provincial and Union Bank of England*, 1 King's Bench 461 (Court of Appeal 1924).

65. This section is adapted from William Blair, *European Banking Law* 33–34 (R. Cranston ed., 1993).

66. Public Law No. 96–510, 94 Stat. 2767 (1980).

67. Public Law No. 99–499, 100 Stat. 1613 (1986).

68. 42 U.S.C. § 9601(20)(A) (1995).

69. *E.g., United States v. Fleet Factors,* 901 F.2d 1550 (11th Cir. 1990), *cert. denied,* 498 U.S. 1046 (1991).

70. The Environmental Protection Agency (EPA) had issued regulations, 57 Federal Register 18344 (1992), providing when secured creditors would be liable within the meaning of the Federal Comprehensive Environmental Response, Compensation and Liability Act of 1980. 42 U.S.C. §§ 9601 *et seq.* (1994). In *Kelley ex rel. Michigan v. United States Environmental Protection Agency,* 15 F.3d 1100 (D.C. Cir. 1994), the D.C. Circuit Court of Appeals held that the EPA lacked the statutory authority to issue such regulations. The U.S. Supreme Court denied review of the decision. *American Bankers Ass'n v. Kelley,* U.S. No. 94–752. However, legislation has been introduced in the Congress to provide statutory relief concerning lender liability under federal environmental statutes. H.R. 1362, 104th Congress, 1st Session, § 301 (1995); *see also* H.R. 3800, 103d Congress, 2d Session, § 407 (1994), H.R. 4916, 103d Congress, 2d Session, § 407 (1994).

71. 1991 O.J. (C 192) 6.

72. Commission of the European Communities, *Communication from the Commission to the Council and Parliament and the Economic and Social Committee: Green Paper on Remedying Environmental Damage*, COM(93) 47 final (May 14, 1993).

73. David Cuckson, *The Hazards of Buying and Selling Contaminated Land,* 8 International Company & Commercial Law Review 278 (1992).

74. Environmental Protection Act, 1990, Chapter 43.

75. *Id.* § 4(2).

76. *Id.* § 61.

77. Water Resources Act, 1991, Chapter 57.

78. A number of recent articles contain helpful analyses of the potential risks for lenders. *See, e.g.,* Beringer & Thomas, *Lenders and Environmental Liability,* Practical Law for Companies 3 (November 1991). The courts have leaned against imposing retrospective liability for pollution. *See Cambridge Water Co. Ltd. v. Eastern Counties Leather plc,* 1 All E.R. 53 (House of Lords, 1994).

79. *Barclays Bank plc v. O'Brien*, 1 App. Cas. 180 (1994).

80. *CIBC Mortgages plc v. Pitt,* 1 App. Cas. 200 (1994).

81. *Massey v. Midland Bank plc*, unreported (March 18, 1994).

82. Unfair Contract Terms Act, 1977, Chapter 50.

83. *Standard Chartered Bank v. Walker*, 1 W.L.R. 1410 (1982).

84. Council Directive 93/13 of 5 April 1993 on Unfair Terms in Consumer Contracts, 1993 O.J. (L 95) 29.

85. The British Bankers' Association, the Building Societies Association, & the Association for Payment Clearing Services, *Good Banking* (2d ed. March 1994), *reprinted in* 3 *Current Legal Issues Affecting Central Banks, supra* note 19, at 541.

86. As the court did in the *O'Brien* case, *supra* note 79. A code along similar principles was released by the Australian Bankers' Association on November 3, 1993.

87. *See Banking Services: Law and Practice Report by the Review Committee*, Command Paper No. 622, Appendix H (R.B. Jack CBE ed., 1989).

88. Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters, September 27, 1968, as amended by the Convention of the Accession to the 1968 Convention of Denmark, the Republic of Ireland and the United Kingdom, October 8, 1978, 1978 O.J. (L 304) 77, *reprinted in* Alan Dashwood, Richard J. Hacon, & Robin C.A. White, *A Guide to Civil Jurisdiction and Judgments Convention* 63 (1987).

89. Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters, September 16, 1988 [hereinafter Lugano Convention], *reprinted in* Pierre A. Karrer, Karl W. Arnold & Paolo Michele Patocchi, *Switzerland's Private International Law* (2d ed. 1994). The Lugano Convention came into force for the United Kingdom on May 1, 1992.

90. *Id.* Art. 5(1). Special rules apply to consumer contracts.

91. *Id.* Art. 5(3) (as interpreted in a number of decisions of the European Court of Justice, including *Case 21/76 Bier Mines de Potasse d'Alsace,* 1976 European Community Reports [E.C.R.] 1735 (1976) and *Case C-220/88, Dumez France and Tracoba v. Hessische Landesbank*, 1990 E.C.R. I-49 (1990)).

92. If necessary, by injunction restraining foreign proceedings. *Continental Bank NA v. Acakos Compania Naviera SA*, [1994] 1 W.L.R. 558.

93. Convention on the Law Applicable to Contractual Obligations 80/934, June 19, 1980 [hereinafter Rome Convention], *reprinted in* Richard Plender, *The European Contracts Convention* 199 (1991). In English law, it is given effect by the Contracts (Applicable Law) Act, 1990, Chapter 36.

94. 2 *Dicey and Morris on the Conflict of Laws* 1196 (Lawrence Collins ed., 12th ed. 1993).

95. Rome Convention, *supra* note 93, Art. 4(1).

96. *X AG and others v. A bank*, 2 All E.R. 464 (Queens Bench Division Commercial Court 1983); *Libyan Arab Foreign Bank v. Bankers Trust Co.*, 1 Q.B. 728 (1989).

97. Mario Giuliano & Paul Lagarde, *Report on the Convention of the Law Applicable to Contractual Obligations, reprinted in The European Contracts Convention, supra* note 93, at 243.

98. *Id.* Art. 4, paragraph 3.

99. *Attock Cement Co. Ltd. v. Romanian Bank for Foreign Trade*, 1 W.L.R. 1147 (Court of Appeal 1989).

100. *Turkiye Is Bankasi AS v. Bank of China,* 1 Banking Law Report [L.R.] 132 (1993); *Wahda Bank v. Arab Bank plc*, unreported, (November 7, 1995). The latter case is subject to appeal. Where the parties expressly incorporate the International Chamber of Commerce uniform rules for demand guarantees, unless otherwise agreed the governing law is the law of the place of the branch that issued the guarantee or counterguarantee. Rome Convention, *supra* note 93, Art. 27.

101. Giuliano & Lagarde, *supra* note 97, Art. 4, paragraph 3.

102. *Libyan Arab Foreign Bank v. Bankers Trust Co., supra* note 96. It should be noted that in *Libyan Arab Foreign Bank v. Bankers Trust Co., supra,* no reference was made to

Article VIII, Section 2(b) of the International Monetary Fund's Articles of Agreement. *See also Libyan Arab Foreign Bank v. Manufacturers Hanover Trust Co. (No. 2),* 1989 1 L.R. 608 (1989).

103. *Wahda Bank v. Arab Bank plc,* 2 Bank L.R. 233 (1993), *later proceedings* 2 L.R. 411 (Queen's Bench Division Commercial Court 1994).

104. *R. v. HM Treasury ex parte Contro-Com Sarl,* unreported. The case was decided under the Serbia and Montenegro (United Nations Sanctions) Order, 1992, made under the provisions of the United Nations Act, 1946.

105. *See Bankers Trust* case, *supra* note 96, at 772; *Arab Bank Ltd. v. Barclays Bank (DCO),* 1954 App. Cas. 495 (1954).

Chapter **14**, "Banking Law Developments in Canada" (David)

1. Department of Finance, *The Regulation of Financial Institutions: Proposals for Discussion* (Technical Supplement, June 1985).

2. *A Framework for Financial Regulation* (1987).

3. *See* Bank Act, I Statutes of Canada Chapter B-1.01 (1993)(noting the Bank Act was assented to December 13, 1991).

4. *Id.*

5. Constitution Act, 1982, Art. 92.

6. Bank Act, *supra,* note 3, § 52 (1)(b).

7. *See id.* § 375(1)

8. *Id.* § 373(2).

9. *Id.* § 374.

10. *Id.* § 381.

11. *Id.* § 376.1.

12. *Id.* § 465.

13. *Id.* § 466–482.

14. *Id.* § 466.

15. *Id.* § 468.

16. *Id.* § 479.

17. *See* Basle Committee on Banking Regulations and Supervisory Practices, *Report on International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended in 1992, 1994, and 1995). The Basle Capital Accord is reprinted in 1 *Current Legal Issues Affecting Central Banks* 487 (Robert C. Effros ed., 1992). The 1992 amendment is reprinted in 3 *Current Legal Issues Affecting Central Banks* 296 (Robert C. Effros ed., 1995). Further amendments are reprinted herein as Appendix II(11).

18. Bank Act, *supra* note 3, Part XI (Self-Dealing). *See also* Trust and Loan Companies Act (Canada), Part XI.

19. Bank Act, *supra* note 3, §§ 486, 489.

20. *Id.* § 490 *et seq.*

21. *Id.* § 499 (1).

22. *Id.* § 486.

23. *Id.* § 486(3), (4).

24. *Id.* § 157.

Chapters **13** and **14**, Comment (Fein)

1. Free Trade Agreement, December 22–23, 1987, and January 2, 1988, Canada-United States, *reprinted in* 27 International Legal Materials [I.L.M.] 281 (1988).

2. North American Free Trade Agreement, December 8, 11, 14, and 17, 1992, Canada-Mexico-United States, *reprinted in* 32 I.L.M. 605 (1993). Selected provisions are reprinted herein as Appendix I(2).

3. Second Council Directive 89/646 of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 Official Journal of the European Communities [O.J.] (L 386) 1, as corrected 1990 O.J. (L 83) 128 and 1990 O.J. (L 158) 87, *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 251 (Robert C. Effros ed., 1994).

4. *See* Peter J. Wallison, *The Decline of National Treatment In U.S. Financial Services Trade Policy, in* 3 *Current Legal Issues Affecting Central Banks* 175 (Robert C. Effros ed., 1995).

5. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Public Law No. 103–328, 108 Stat. 2338 (1994).

6. *See* Bradley Crawford, *Overview of Developments in Canadian Financial Services Law, in* 3 *Current Legal Issues Affecting Central Banks, supra* note 4, at 201.

7. The Glass-Steagall Act of 1933 is composed of sections 16, 20, 21, and 32 of the Banking Act of 1933 (Act of June 16, 1933, Chapter 89, 48 Stat. 162), codified at 12 U.S.C. §§ 24 (Seventh), 78, 377–78 (1933).

8. Bank Act, I Statutes of Canada Chapter B-1.01, § 465 (1991)(providing "[t]he directors of a bank shall establish and the bank shall adhere to investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return.").

9. *See* Melanie L. Fein, *Which Way the Wind Is Blowing, in Mutual Fund Activities of Banks* 4 (1994).

10. H.R. 1362, 104th Congress, 1st Session § 301 (1995); H.R. 3800, 103d Congress, 2d Session, § 407 (1994); H.R. 4916, 103d Congress, 2d Session, § 407 (1994).

11. Community Reinvestment Act of 1977, Public Law No. 95–128, Title VIII, 91 Stat. 1147 (current version at 12 U.S.C. § 2901 *et seq.* (1994)).

12. Riegle Community Development and Regulatory Improvement Act of 1994, Public Law No. 103-325, 108 Stat. 2160 (1994).

13. *See* Michael F. Zeldin, *Money Laundering: Legal Issues, in* 2 *Current Legal Issues Affecting Central Banks, supra* note 3, at 209.

14. *See supra* William Blair, *Banking Law Developments in the United Kingdom (Chapter 13); see also* Hugh Pigott, *Banking Law Developments in the United Kingdom, in* 3 *Current Legal Issues Affecting Central Banks, supra* note 4, at 189.

15. Revised Statutes of Canada Chapter 42, § 2 (1985)(4th Supp.)(enacting § 462 *et seq.*, which added sections to the criminal code of Canada); *see* Michael Ballard, *The Canadian Banks' Approach to Fighting Money Laundering,* 9 World of Banking 12 (1990).

Chapter 15, "Banking Law Developments in the Former Soviet Union" (Shea)

1. World Bank, *Russia: The Banking System During Transition* 9 (1993).

2. *Id.*

3. *Id.* at 11.

4. *Id.* at 32.

5. *See* Central Bank of the Russian Federation, *Conditions for Opening Banks with the Participation of Foreign Investment in the Territory of the Russian Federation*, Letter No. 14 (April 8, 1993).

6. Agreement on Partnership and Cooperation Establishing a Partnership Between the European Communities and their Member States, of the One Part, and the Russian Federation, of the Other Part, June 24, 1994, E.C.-Russian Federation *in* Commission of the European Communities, *Proposal for a Council and Commission Decision on the Conclusion of the Agreement on Partnership and Cooperation between the European Communities and their Member States of the One Part, and Russia, of the Other Part,*

COM(94) 257 final (June 15, 1994); *see EU Press Release on Russia-EU Economic Agreement*, IP/94/565 (June 23, 1994).

7. World Bank, *supra* note 1, at 13, 22.

8. *Id.* at 17.

9. *Id.* at 17, 46.

10. *Id.* at 17.

11. *Id.* (for example, transfer payments for utility fees, taxes, and pensions).

12. *Id.* at 9; *see* Law of the RSFSR On Banks and Banking in the RSFSR, as proposed to be amended, Art. 11 (December 2, 1990)(proposing that the Bank of Russia be empowered to set a standard minimum amount of capital), *reprinted in* F.B.I.S., U.S.R., November 22, 1994, at 1; *see also Draft Law Reimposes Bank Restrictions,* The Moscow Times, June 28, 1994, § 491 (noting that according to official data only 7 percent of Russian banks pass the Central Bank's minimum charter capital requirement of Rub 2 billion).

13. Second Council Directive 89/646 of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, Art. 4, 1989 Official Journal of the European Communities (L 386) 1, *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 264 (Robert C. Effros ed., 1994).

14. *See* 12 U.S.C. §§ 375a, 375b (1994).

15. World Bank, *supra* note 1, at 26–32.

16. The rationale behind the International Standards Bank (ISB) program is that all banks should be improved over time, but, for three reasons, it is not practicable to do so at once by massive restructuring, recapitalization, and privatization. First, the household deposits outside Sberbank are small, thus attenuating the banking sector's exposure to systemic risk. Second, public funds should not be used to recapitalize banks claiming to be profitable; in any case, it would be risky as the lack of supervisory capacity would probably lead to relapse (as has, indeed, happened in the Kyrgyz Republic already). Third, problems of connected lending and insider lending need to be dealt with by enforcing regulatory restrictions, not by attempting a massive change in the ownership structure. (Probably, the same owners would simply be reshuffled; in any case, there is no clear alternative source of skills and capital.)

The solution, therefore, is to aim quickly to produce a core of banks that are better capitalized, managed, and supervised. Other banks can graduate to become ISBs if they improve their standards. However, it is desirable that all new banks should be required to adopt ISB standards. Other objectives include gradually raising the level of soundness of the banking system as the number of ISBs and their share of banking activities increase; improving the portion of credit allocated on an "arms-length" basis; providing the public with information to recognize the most appropriate banks; and helping the banking system integrate itself into the international financial markets. *Id.* at 26.

The standards, for example, require

- banks' meeting of Basle Committee on Banking Supervision standards for capital regarding definition and amount;
- large exposure limits of 25 percent of capital, with an aggregate level of 800 percent for individual exposures over 10 percent of capital;
- quarterly reports to the Central Bank on all large exposures (over 10 percent of capital, or 5 percent if connected parties);
- limits on connected lending of 10 percent of capital or 20 percent in aggregate, and an arms-length lending rule;
- high levels of initial capital, adjusted annually in light of inflation;
- identification of nonperforming loans and maintenance of proper loan loss reserves;
- adoption of proper accounting standards and procedures and submission of appropriate reports to the Central Bank;

- an external audit annually, from a list provided by the Central Bank; and
- adherence to a code of conduct, prepared by the Central Bank, regulating relations with customers.

Id. at 28.

17. Examples of possible benefits to ISBs include
    - right to public designation as ISB (which could lead, for example, to paying lower rates for deposits);
    - lower cost of borrowing from the Central Bank (either by lower discount rate or cheaper collateral);
    - preferential treatment in relation to insurance for household deposits (for example, through cheaper premiums or by requiring non-ISBs to invest 100 percent of household deposits with the Central Bank in low-yield accounts to qualify for deposit insurance, thus directing most household deposits to Sberbank and the ISBs and preventing new systemic problems from developing);
    - lower risk weight for capital adequacy purposes;
    - limiting of Sberbank's lending only to ISBs into the interbank market;
    - easier expansion through automatic approval of branches and preferential access to bidding for failing banks;
    - exclusive right to be accredited as participating banks under future APEX lending schemes funded by international financial institutions; and
    - support in financing advisory services, management contracts, and other types of twinning arrangements with foreign banks.

Id. at 28–29.

18. The risks of the program, among others, are that
    - insufficient banks may be attracted to the program;
    - non-ISBs may react in various detrimental ways, for example, by raising interest rates or lowering even further credit standards in lending, so as to complicate the operations of ISBs and further endanger the banking system and the whole economy; and
    - the failure of some ISBs through inadequate central bank supervision may damage the reputation of all and imperil the whole program.

Id. at 30.

19. *Id.* at 39.
20. *Id.* at 46.
21. *Id.*
22. *Id.* at 33.
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. *Id.* at 37–39.
28. *Id.* at 35–36.
29. *Id.*
30. *Id.*
31. *Id.* 35–36, 43–46.

Chapter **15**, Comment (Burand)

1. Zakon Turkmenistana O Bankax i Bankovskoi Deyatalnosti [Law of Turkmenistan on Banks and Banking Activities], No. 696 (May 19, 1992).
2. Zakon Turkmenistana O Kommercheskik Bankax i Bankovskoi Deyatalnosti [Law of Turkmenistan on Commercial Banks and Banking Activities], October 8, 1993, ***reprinted in*** Turkmenskaya Iskra, November 23, 1993, at 2.
3. *Id.* Art. 1.

4. *Id.* Art. 10.

5. Law of Turkmenistan on Commercial Banks and Banking Activities, ***supra*** note 2, Art. 10.

6. *Cf.* Law of Turkmenistan on Commercial Banks and Banking Activities, ***supra*** note 2, Art. 13 and Law of the RSFSR On Banks and Banking in the RSFSR, as proposed to be amended, Art. 5 (December 2, 1990), ***reprinted in*** F.B.I.S., U.S.R., November 22, 1994, at 1.

7. Law of Turkmenistan on Commercial Banks and Banking Activities, ***supra*** note 2, Art. 9.

Chapter 16, Comment (N. Lichtenstein)

1. Constitution of the People's Republic of China, Arts. 6–13 (adopted on December 4, 1982), as amended April 12, 1988 and March 29, 1993.

2. Zhonghua renmin gongheguo min fa tong ze [General Principles of the Civil Law of the People's Republic of China], (promulgated by Order No. 37 of April 12, 1986), 1986 Fagui Huibian 1, ***reprinted in*** I ***Laws and Regulations of the People's Republic of China Governing Foreign-Related Matters*** 331 (1991).

3. Company Law of the People's Republic of China (December 29, 1993)(cited in ***China's Company Law Guides Reform,*** XIII International Financial Law Review No. 4, at 13 (April 1994)).

4. Economic Contract Law of the People's Republic of China (adopted December 13, 1981), as amended September 2, 1993.

5. Patent Law of the People's Republic of China, as amended (adopted on March 12, 1984 and amended on September 4, 1992); Zhonghua renmin gongheguo shangbiao fa [Trademark Law of the People's Republic of China] (August 23, 1982), ***as amended by*** Decision of the Standing Committee of the National People's Congress to Amend the Trademark Law of the People's Republic of China (promulgated on February 22, 1993), ***reprinted in Trademark Law Amendments,*** 15 East Asian Executive Reports No. 3, at 24 (March 1993); Zhonghua renmin gongheguo shangbiao fashi shixize [Implementing Regulations under the Trademark Law] (promulgated on January 13, 1988)(cited in Mitchell Silk, ***China's Drive to Protect Intellectual Property Rights: The 1988 Trademark Rules,*** 10 East Asian Executive Reports 8 (June 1988)); Copyright Law of the People's Republic of China (September 7, 1990), ***reprinted in Foreign Investment in China: The New Reality*** Part 6, at 52 (1993); Memorandum of Understanding between the Government of the United States and of the Government of the People's Republic of China on the Protection of Intellectual Property (January 1992); *see* William Alford, ***To Steal A Book Is an Elegant Offense: Intellectual Property Law in Chinese Civilization*** (1995).

6. Zhonghua renmin gongheguo fanbuzheng dang jingzhengafa [Anti-Unfair Competition Law of the People's Republic of China] (September 2, 1993)(cited in Jianyang Yu, ***Protection of Intellectual Property in the P.R.C.: Progress, Problems, and Proposals,*** 13 UCLA Pacific Basin Law Journal 140, 145 n. 12 (1994)).

7. Law of the People's Republic of China on Protection of Consumer Rights (October 31, 1993).

8. Zhonghua renmin gongheguo qiye pochan fa (shixing) [Enterprise Bankruptcy Law of the People's Republic of China (for Trial Implementation)], 1986 Fagui Huibian 58 (cited in Donald C. Clarke, ***Regulation and its Discontents: Understanding Economic Law in China,*** 28 Stanford Journal of International Law 283, 298 n. 44 (1992) and noting the law is ***translated in*** 19 Vanderbilt Journal of Transnational Law 733 (Henry R. Zheng trans., 1986)).

9. Law of the People's Republic of China on Civil Procedure (promulgated by Decree No. 44 on April 9, 1991), ***reprinted in Foreign Investment in China: The New Reality, supra*** note 5, Part 6, at 1.

10. Measures of Shanghai Municipality for Administration of Trading of Securities (November 27, 1990)(cited in Grace K.W. Chan, *China,* Capital Markets Yearbook 1994, at 20 (Special Supplement to the International Financial Law Review, October 1994)); Provisional Measures of Shenzhen Municipality for Administration of the Issue and Trading of Shares (May 15, 1991)(cited in *China, supra,* at 20); *see* Interim Provisions on Management of the Issuing and Trading of Stocks (April 22, 1993), China Economic News No. 21–23 (1993).

11. Law of the People's Republic of China on the People's Bank of China (March 18, 1995); Commercial Bank Law of the People's Republic of China (May 10, 1995).

12. American Bar Association, *Model Rules of Professional Conduct* (as amended, August 1991), *reprinted in 1992 Selected Standards on Professional Responsibility* 1 (Thomas D. Morgan & Ronald D. Rotunda eds., 1992); American Bar Association, *Model Code of Professional Responsibility* (as amended, 1981), *reprinted in 1992 Selected Standards, supra,* at 129.

Chapter **17A**, The Role of the Central Bank" (Promisel)

1. *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* 26 (November 1990), *reprinted herein in part* as Appendix II(9).

Chapter **17B**, "Bank Supervision in the G-7 Countries" (Roberts)

1. Banking Act, 1979, Chapter 37.

2. *See herein* Paolo Clarotti, *Banking Law Developments in the European Union: Deposit Insurance and Money-Laundering Initiatives* (Chapter 7) and René Smits, *The European Community's Second Banking Directive* (Chapter 6).

3. *See* The Interstate Banking and Branching Efficiency Act, Public Law No. 103–328, 108 Stat. 2338 (1994); *see generally* Murray A. Indick & Satish M. Kini, *The Interstate Banking and Branching Efficiency Act: New Options, New Problems*, 112 Banking Law Journal 100 (1995).

4. *See herein* Jacques Milleret, *Who Should Be the Banking Supervisors? French Banking Supervision* (Chapter 18D).

5. Gesetz über das Kreditwesen [German Banking Law] vom 3. Mai 1976, Bundesgesetzblatt I S. 1121 § 5 (1976).

6. Banking Act, 1987, Chapter 22.

7. *Id.* § 2.

8. Financial Services Act, 1986, Chapter 60.

9. Legislative Decree 385 of September 1, 1993, Art. 4 (1993), *reprinted in* Banca D'Italia, *Quaderni di ricerca giuridica della Consulenze Legale No. 33* (April 1994).

10. Loi no. 93.980 du 4 août 1993 relative au statut de la Banque de France et à l'activité et au contrôle des établissements de crédit modifiée par la loi no. 93.1444 du 31 décembre 1993, Journal Officiel 11047 (August 6, 1993).

11. Treasury and Civil Service Committee, 1 *The Role of the Bank of England*, First Report, House of Commons Session 1993–94 (December 8, 1993).

Chapters **17A–B**, Comment (Danforth)

1. The Bank Regulatory Consolidation and Reform Act of 1995, H.R. 17, 104th Congress, 1st Session (1995); Regulatory Consolidation Act of 1994, S. 1985, 103d Congress, 2d Session (1994); Regulatory Consolidation Act of 1993, H.R. 1214, 103d Congress, 1st Session (1993). Regarding the U.S. Department of Treasury proposal, *see* Jerry Knight, *Bentsen Backs Single Bank Agency; Move to Streamline Regulation Draws Federal Reserve Opposition*, The Washington Post, November 24, 1993, at D1; *Treasury Secretary Outlines Banking-Agency Consolidation; the Clinton Administration Has Proposed a Merger to Create a Single Commission*, The Orlando Sentinel, November 24, 1993, at C1; *see generally* Claudia Cummins, *Fed Girding to Fight Plan for a Single Bank Regulator*, The American Banker, December 20, 1993, at 1; Robert M. Garsson, *Rep. Leach Assails Plan to Merge the Regulators*, The American Banker, December 17, 1993, at 3.

Chapter 18A, "Some General Considerations" (Giddy)

1. Other means, such as ceilings on credit volume, restrictions on the payment of interest on deposits, and the maintenance of certain ratios between different kinds of assets and between different kinds of assets and liabilities, may be considered useful, but they are not absolutely necessary to achieve the basic objective of monetary control. Indeed, such methods generally have a secondary objective associated with the allocation of credit.

2. This section borrows in part from Roger C. Kormendi *et al.*, *The Origins and Resolution of the Thrift Crisis*, Journal of Applied Corp. Finance (1989). The original idea appeared in Robert C. Merton, *An Analytic Derivation of the Cost of Deposit Insurance and Loan Guarantees: An Application of Modern Option Pricing Theory*, 1 Journal of Banking & Finance 3 (1977).

3. For a comprehensive review of the patterns of bank supervision, *see* Richard Dale, *Bank Supervision Around the World* (1982).

4. National banks are authorized, under 12 U.S.C. § 24 Seventh, to purchase for their own account investment securities evidencing indebtedness of corporations in the form of bonds, notes, and/or debentures, up to 10 percent of their capital stock and surplus pursuant to regulations prescribed by the Comptroller of the Currency. 12 U.S.C. § 24 Seventh (1994). Generally, an insured state bank may not acquire or retain any equity investment of a type that is impermissible for a national bank. 12 U.S.C. § 1831a(c) (1994); *see also* Raymond Natter *et al.*, 1 *Banking Law* § 2.04[27] (1995).

5. Community Reinvestment Act of 1977, Public Law No. 95–128, Title VIII, 91 Stat. 1147 (current version at 12 U.S.C. § 2901 *et seq.*).

6. *Id.* § 2903.

7. *See* Donald R. Hidgman, Banking Research Fund, *Selected Credit Controls in Western Europe* (1976).

8. *See* Ronald I. McKinnon, *Money and Capital in Economic Development* (1973).

9. Basle Committee on Banking Supervision, *Report on International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended in 1992, 1994, and 1995). The Basle Capital Accord is reprinted in 1 *Current Legal Issues Affecting Central Banks* 487 (Robert C. Effros ed., 1992). The 1992 amendment is reprinted in 3 *Current Legal Issues Affecting Central Banks* 296 (Robert C. Effros ed., 1995). Further amendments are reprinted herein as Appendix II(11).

10. 12 U.S.C. § 1817(b)(1)(c)(i) (1994).

11. *Id.* § 1817(b)(2)(G)(i).

12. Edward J. Kane, *How Market Forces Influence the Structure of Financial Regulation*, *in Restructuring Banking and Financial Services in America* 343 (William S. Haraf & Rose Marie Kushmeider eds., 1988). For a concise survey of the issues involved in bank regulation, *see* Terence Quinn, *The Economics of Financial Regulation: A Survey* 55–70 (1992).

13. This process will, in turn, dilute regulatory efforts; in "globalizing" markets, the effect is heightened by an increase in the availability of regulators. *See* Ian H. Giddy, *Domestic Regulation vs. International Competition in Banking*, Kredit und Kapital 193 (August 1984).

14. *See herein* Fé Morales Marks, *Banking Reform in the United States* (Chapter 12); *see also* Jerry Knight, *Bentsen Backs Single Bank Agency; Move to Streamline Regulation Draws Federal Reserve Opposition*, The Washington Post, November 24, 1993, at D1; *Treasury Secretary Outlines Banking-Agency Consolidation; the Clinton Administration Has Proposed a Merger to Create a Single Commission*, The Orlando Sentinel, November 24, 1993, at C1; *see generally* Claudia Cummins, *Fed Girding to Fight Plan for a Single Bank Regulator*, The American Banker, December 20, 1993, at 1; Robert M. Garsson, *Rep. Leach Assails Plan to Merge the Regulators,* The American Banker, December 17, 1993, at 3.

15. Sam Y. Cross, *Following the Bundesbank*, Foreign Affairs, March–April 1994, at 128, 132 (reviewing David Marsh, *The Most Powerful Bank: Inside Germany's Bundesbank* (1992)).

16. *Id.* at 132–133 (quoting Alan Greenspan).

17. *Id.* at 133 (quoting William J. McDonough).

18. Then U.S. Federal Reserve Governor John P. LaWare in a speech on March 7, 1994 stated:

> The idea of a monopoly regulator for the entire banking system almost assures a too-restrictive regulatory environment, one which would be likely to stifle innovation and so limit risk-taking that there could be serious negative impact on the econ-

omy. A single regulator with no other responsibilities would tend to want to eliminate bank failures and consequently limit risk-taking in the industry to the point where it would shut off the flow of credit to support commerce. A single regulator, which would have state-chartered banks as well as national banks under its rule-making authority, would inevitably have the tendency to blur the distinction between a national bank charter and a state bank charter, spelling the eventual demise of the dual banking system which has served the country well for 131 years. In any case, banks would no longer have a choice of federal regulators and no way to escape from over-restrictive regulatory policies by changing charter. The Treasury proposal removes all rule-making and most supervisory and examination functions from the Federal Reserve. I believe that hands-on involvement and supervision, rule-making and examinations over a broad spectrum of banking organizations is essential to enable the Federal Reserve to discharge its responsibilities for the integrity of the payment system, the operation of the window as the lender of last resort, and as the central player in crisis management when there is an accident in the financial system which might destabilize the system. Putting the entire banking system under one agency that is at least potentially more vulnerable to political manipulation does not appear to me to be good public policy. A better approach would be to have two regulators at the federal level. This could most directly be accomplished by merging the Office of Thrift Supervision and the Office of the Comptroller of the Currency, thus combining the two agencies presently responsible for federally-chartered institutions. The second step would be to transfer responsibility for state-chartered nonmember banks to the Federal Reserve, which already has oversight of state member banks. This would reduce the number of federal regulators from four to two and strongly underscore the importance of the dual banking system by having one federal regulator for federally-chartered banks and a separate one for state-chartered banks. Because there is a small group of 30 to 40 banking organizations which are so large and have such reach to their operations that they are special, both agencies should have some degree of oversight. This could be accomplished by joint examination of the parent holding companies and the lead banks. In all other cases duplicative examination and overlapping supervision could be eliminated by giving top-to-bottom supervision and examination authority to the regulator of the lead bank.

Our proposal has the following advantages:

- It avoids overrestrictive and stultifying rule-making by a monopoly regulator;
- It provides strong support for the dual banking system at the federal level;
- It maintains the role in bank supervision critical to the Federal Reserve's needs;
- It provides choice of federal regulator to banks;
- It reduces federal regulators from four to two;
- With the exception of a small, special group of banks, it assures one examiner per banking organization;
- And it maintains a healthy, dynamic tension between the two agencies in rule-making.

19. *The Need for Major Consolidation and Overhaul of the Bank Regulatory Agencies into a New and Independent Banking Structure: Hearings Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate,* 103d Congress, 2d Session, at 18 (1994) (statement of Secretary of the Treasury Lloyd Bentsen). The Bundesbank, according to a recent book, has no direct responsibility for bank supervision; the Federal Banking Supervisory Office carries out this function. However, in fact, the Federal Banking Supervisory Office makes its decisions after consultation with the Bundesbank, helping ensure that the Bundesbank has access to the information it needs. David Marsh, *The Most Powerful Bank: Inside Germany's Bundesbank* (1992). *See herein* Bertold Wahlig, *"Who Should Be the Banking Supervisors? A German Perspective"* (Chapter 18B).

20. *The Need for Major Consolidation and Overhaul of the Bank Regulatory Agencies into a New and Independent Banking Structure, supra* note 19, at 19–20.

21. Treaty Establishing the European Communities, as amended by Treaty on European Union, Art. 107, February 7, 1992, 1992 Official Journal of the European Communities

(C 224) 1, *selected provisions reprinted in* 3 *Current Legal Issues Affecting Central Banks, supra* note 9, at 325.

22. Loi no. 93.980 du 4 août 1993 relative au statut de la Banque de France et à l'activité et au contrôle des établissements de crédit modifiée par la loi no. 93.1444 du 31 décembre 1993, Journal Officiel 11047 (August 6, 1993); Law 13/1994 of June 1, 1994 on the Autonomy of the Banco de España, Boletín Oficial del Estado (June 2, 1994).

23. Constitution of the Republic of Chile, Arts. 97, 98, *reprinted in* IV *Constitutions of the Countries of the World* (Albert P. Blaustein & Gisbert H. Flanz eds., 1994); Constitutional Organic Act of the Central Bank of Chile, Official Gazette Law No. 18,840 (March 10, 1990), as amended by Law No. 18,901 (January 6, 1990) and Law No. 18,970 (October 10, 1989); Ley del Banco de México, Art. 1, Diario Oficial Section 2, at 1 (December 23, 1993); Decreto por el que se reforman los articulos 28, 73, y 123 de la Constitucíon Politica de los Estados Unidos Mexicanos, Diario Oficial 2 (August 20, 1993); Iniciativa Presidencial de Reform Constitucional Enviada al Congreso de la Unión por el Presidente Carlos Salinas de Gortari el 2 de mayo de 1900, Diario Oficial (June 27, 1990); Ley del Banco Central de la Republica Argentina, Art. 3, No. 193 of 1991 (November 6, 1991).

24. *Following the Bundesbank, supra* note 15, at 133 (reviewing David Marsh, *supra* note 19, and quoting Otmar Issing).

25. The Centre for Economic Policy Research, *Independent and Accountable—A New Mandate for the Bank of England* 28–30 (1993) (report of an independent panel chaired by Eric Roll).

26. *Id.* at 31, 65–66, 70.

27. *Id.* at 67.

Chapter **18B**, "A German Perspective" (Wahlig)

1. Rinaldo M. Pecchioli, *Bankenaufsicht in den OECD-Ländern: Entwicklungen und Probleme* [Banking Supervision in the OECD Countries: Trends and Problems] 29 (1989).

2. *See* Basle Committee on Banking Supervision, *Report on International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended in 1992, 1994, and 1995). The Basle Capital Accord is *reprinted in* 1 *Current Legal Issues Affecting Central Banks* 487 (Robert C. Effros ed., 1992). The 1992 amendment is *reprinted in* 3 *Current Legal Issues Affecting Central Banks* 296 (Robert C. Effros ed., 1995). Further amendments are reprinted herein as Appendix II(11).

3. *See herein* Paolo Clarotti, *Banking Law Developments in the European Union: Deposit Insurance and Money-Laundering Initiatives* (Chapter 7) and René Smits, *The European Community's Second Banking Directive* (Chapter 6).

4. Pecchioli, *supra* note 1, at 31.

5. *Id.*

6. *See* Volkhard Szagunn & Karl Wohlschiess, *Gesetz über das Kreditwessen* [Banking Act] 53 (5th ed. 1990); Banking Act of the Federal Republic of Germany, Deutsche Bundesbank Special Series No. 2 (4th ed. 1993).

7. *See* Paolo Clarotti, *supra* note 3.

8. Federal Court of Justice, Rulings of February 15 and July 12, 1979, Wertpapier-Milleilungen 1979 [Securities Information 1979].

9. Gesetz über das Kreditwesen [Banking Act], as amended, Federal Law Gazette I, 1472 (July 11, 1985).

10. *See* H.J. Muller, *The Central Bank and Banking Supervision*, De Nederlandsche Bank N.V. Quarterly Bulletin (September 1983), *reprinted in* 3 International Banking Law 2 (June 1984).

11. Gesetz über die Deutsche Bundesbank [Bundesbank Act], as amended through December 1992, § 3 (English translation citing Bundesgesetzblatt 745 (July 30, 1957), and subsequent amendments).

12. Treaty Establishing the European Community, as amended by Treaty on European Union, February 7, 1992, 1992 Official Journal of the European Communities (C 224) 1, *selected provisions reprinted in* 3 *Current Legal Issues Affecting Central Banks, supra* note 2, at 325.

13. *Id.* Art. 105(1).

14. 2 *The New Palgrave Dictionary of Money and Finance* 571 (1992).

15. Muller, *supra* note 10, at 3.

16. *Pressekommuniqué der am 9. September in Basel versammelten Notenbank-Gouverneure*, Deutsche Bundesbank Auszüge aus Presseartikeln No. 58 at 1 (September 12, 1974).

17. Frederic S. Mishkin, *Preventing Financial Crises: An International Perspective*, Address at the ESR Banking Research Centre Conference (1993).

18. Bankgesetz of March 14, 1875, Reichsgeselzblatt 177 (1875).

19. Banking Act, *supra* note 9, §§ 5, 6.

20. *Id.* § 7.

21. *Id.* § 10(1) and 12(1).

22. *Id.* § 10(1).

23. *Id.* § 14(1).

24. *Id.* § 14(2).

25. *Deutsche Bundesbank Geschäftsbericht 1993* at 128 (1994).

26. Treaty Establishing the European Community, *supra* note 12, Art. 105(5) and (6).

Chapter 18C, "A Swedish Perspective" (Sparve)

1. The Glass-Steagall Act of 1933 is composed of sections 16, 20, 21, and 32 of the Banking Act of 1933 (Act of June 16, 1933, Chapter 89, 48 Stat. 162), codified at 12 U.S.C. §§ 24 (Seventh), 78, 377–78 (1933).

2. *See* The Bank Regulatory Consolidation and Reform Act of 1995, H.R. 17, 104th Congress, 1st Session (1995); Regulatory Consolidation Act of 1994, S. 1985, 103d Congress, 2d Session (1994); Regulatory Consolidation Act of 1993, H.R. 1214, 103d Congress, 1st Session (1993).

3. *Inquiry into the Supervision of the Bank of Credit and Commerce International* (The Right Honourable Lord Justice Bingham, chairman, October 22, 1992).

4. This is not explicitly stated in the Bank Act, nor in the Articles of Association of De Nederlandsche Bank N.V., but according to established practice, one executive director (out of four members) is the executive director responsible for supervisory matters.

5. Office of the Superintendent of Financial Institutions Act, Statutes of Canada, Chapter F-11.3, Part I, § 4 (1987).

6. In Sweden, for example, supervision of all such institutions and markets is conducted by one single authority since July 1, 1991.

7. Second Council Directive 89/646 of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 Official Journal of the European Communities (L 386) 1, *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 264 (Robert C. Effros ed., 1994); Agreement on the European Economic Area, May 2, 1992, Annex IX ("Financial Services").

Chapter 18D, "French Banking Supervision" (Milleret)

1. Loi no. 84–46 du 24 janvier 1984 relative à l'activité et au contrôle des établissements de crédit, Journal Officiel 390 (January 25, 1984)[hereinafter Law no. 84–46].

2. Loi no. 93.980 du 4 août 1993 relative au statut de la Banque de France et à l'activité et au contrôle des établissements de crédit modifiée par la loi no. 93.1444 du 31 décembre 1993, Journal Officiel 11047 (August 6, 1993)[hereinafter Law no. 93.980].

3. Law no. 84–46, *supra* note 1, Titles II and III.

4. Law no. 93.980, *supra* note 2, Art. 23.

5. Law no. 84–46, *supra* note 1, Art. 30.

6. *Id.* Art. 33.

7. *Id.* Art. 33(8) and Law no. 93.980, *supra* note 2, Art. 25.

8. Law no. 84–46, *supra* note 1, Art. 30.

9. *Id.*

10. *Id.* Art. 32.

11. *Id.* Art. 31.

12. First Council Directive 77/780 of 12 December 1977 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, Art. 1, 1977 Official Journal of the European Communities

[O.J.] (L 322) 30, *reprinted in* 2 *Current Legal Issues Affecting Central Banks* 251 (Robert C. Effros ed., 1992).

13. Law no. 84–46, *supra* note 1, Art. 18.
14. *Id.* Art. 18(1).
15. *Id.* Art. 1.
16. *Id.* Art. 18(1).
17. *Id.* Art. 1.
18. *Id.* Art. 31.
19. *Id.*
20. *Id.* Art. 32.
21. *Id.* Art. 38.
22. *Id.*
23. *Id.* Art. 39.
24. Law no. 93.980, *supra* note 2, Art. 28.
25. *Id.* Art. 37.
26. *Id.*
27. *Id.* Arts. 39–41.
28. *Id.* Art. 40.
29. *Id.*
30. Council Directive 89/647 of 18 December 1989 on a Solvency Ratio for Credit Institutions, 1989 O.J. (L 386) 14, *reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 12, at 297.
31. Council Directive 92/121 of 21 December 1992 on the Monitoring and Control of Large Exposures of Credit Institutions, 1993 O.J. (L 29) 1, *reprinted in* 3 *Current Legal Issues Affecting Central Banks* 444 (Robert C. Effros ed., 1995).
32. Second Council Directive 89/646 of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 O.J. (L 386) 1, as corrected 1990 O.J. (L 83) 128 and 1990 O.J. (L 158) 87, *reprinted in* 2 *Current Legal Issues Affecting Central Banks, supra* note 12, at 251.
33. Law no. 84–46, *supra* note 1, Art. 42.
34. *Id.* Art. 43.
35. *Id.* Art. 45.
36. *Id.*
37. *Id.* Art. 48.
38. *Id.* Art. 52.
39. *Id.*
40. Treaty on European Union, signed in Maastricht on February 7, 1992, 1992 O.J. (C 191) 1.
41. Law no. 93.980, *supra* note 2, Art. 1.
42. *Id.*
43. Treaty Establishing the European Community, February 7, 1992, *incorporating changes made by* Treaty on European Union, *supra* note 41. Selected provisions of the Treaty Establishing the European Community are reprinted in 3 *Current Legal Issues Affecting Central Banks, supra* note 31, at 325.
44. Law no. 93.980, *supra* note 2, Title 1er, Chapter 2, Section 2.
45. *Id.* Title 1er, Chapter 2, Section 3.
46. *Id.* Art. 12.
47. *Id.* Title II, Chapters II and IV.
48. Law no. 84–46, *supra* note 1, Art. 33(8).
49. *Id.* Art. 30.
50. Law no. 93.980, *supra* note 2, Art. 24.
51. *Id.*
52. *Id.* Art. 26.
53. Law no. 84–46, *supra* note 1, Art. 36.
54. Law no. 93.980, *supra* note 2, Art. 28.
55. *Id.*
56. *Id.*

Chapter 19, "BCCI: The Lessons for Banking Supervision" (Baxter and de Saram)

1. This paper was presented by Thomas C. Baxter; only his biography appears in the biographical sketches.

2. Banco Ambrosiano of Milan was the largest private banking group in Italy in the mid-1970s, with operations in 15 countries. In 1982, the Italian authorities ordered the liquidation of Banco Ambrosiano after the discovery of $1.2 billion in insecured lending by the bank. The funds were never recovered, and related losses were spread over 200 financial institutions worldwide.

3. *See* Committee on Banking Regulations and Supervisory Practices, ***Revised Basle Concordat*** (May 1983) and ***Supplement to the Concordat*** (April 1990), both ***reprinted in*** 1 *Current Legal Issues Affecting Central Banks* 475 and 480 (Robert C. Effros ed., 1992).

4. Foreign Bank Supervision Enhancement Act of 1991, Title II, Subtitle A, of the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102–242, 105 Stat. 2236 (1991), ***reprinted in*** 3 *Current Legal Issues Affecting Central Banks* 587 (Robert C. Effros ed., 1995); *see also* Deborah Burand, ***Regulation of Foreign Banks' Entry into the United States under the FBSEA: Implementation and Implications,*** 24 Law & Policy in International Business 1089 (1993); Robert C. Effros, ***Comments on "Regulation of Foreign Banks' Entry into the United States under the FBSEA: Implementation and Implications," A Paper Presented by Deborah Burand,*** 24 Law & Policy in International Business 1125 (1993).

Chapter 19, Comment (Gurwin)

1. Richard Donkin, ***BCCI Provisional Liquidators Run Up Costs of Dollars 200m,*** Financial Times, December 3, 1991, at 10.

2. For a lengthier discussion, *see* Larry Gurwin & Peter Truell, ***False Profits: The Inside Story of BCCI, the World's Most Corrupt Financial Empire*** (1992); Larry Gurwin, ***Who Really Owns First American Bank?,*** Regardies Magazine, May (1990).

3. Memorandum from J.E. Vaez, National Bank Examiner–London, The Comptroller of the Currency, to Robert R. Bench, Associate Deputy Comptroller for International Banking. The Comptroller of the Currency (February 15, 1978), ***in The BCCI Affair: Hearings Before the Subcommitte on Terrorism, Narcotics, and International Operations of the Committee on Foreign Relations of the United States Senate,*** 102d Congress, 2d Session, Part 4 at 15 (1992).

4. *Id.* at 18.

5. Akbar Bilgrami testified before the Kerry Committee on July 30, 1992. ***The BCCI Affair: Hearings Before the Subcommittee on Terrorism, Narcotics, and International Operations of the Committee on Foreign Relations of the United States Senate,*** 102d Congress, 2d Session, Part 6, at 679 (1992).

6. Abdur Sakhia testified before the Kerry Committee on October 22, 1991. ***The BCCI Affair: Hearings Before the Subcommittee on Terrorism, Narcotics, and International Operations of the Committee on Foreign Relation of the United States Senate,*** 102d Congress, 1st Session, Part 2, at 515 (1991).

Chapter 20, "The Role of Deposit Insurance: Financial System Stability and Moral Hazard" (Barth and Brumbaugh)

1. This paper was presented by James R. Barth; only his biography appears in the biographical sketches.

2. Federal Deposit Insurance Corporation Improvement Act, Public Law No. 102–242, 105 Stat. 2236 (1991).

Chapter 20, Comment (Comizio)

1. The author wishes to thank Karen B. Elizaga and Matthew D. Adler, associates at Thacher Proffitt & Wood, for their assistance with this comment.

2. National Commission of Financial Institution Reform, Recovery, and Enforcement, ***Origins and Causes of the S&L Debacle: A Blueprint for Reform*** at 4 (July 1993) [hereinafter National Commission Report].

3. *Id.* at ix.

4. *Id.* at 1.
5. *United States v. Winstar*, 116 S.Ct. 2432, 2440, 135 L.Ed.2d 964, 972 (1996) (citing House Report No. 101–54, part 1, at 292–293 (1989)).
6. *Id.* (citing 12 U.S.C. §§ 1421–1449 (1988 ed.)).
7. *Id.* (citing 12 U.S.C. §§ 1461–1468 (1988 ed.)).
8. *Id.* (citing 12 U.S.C. §§ 1701–1750g (1988 ed.)).
9. National Commission Report, *supra* note 2, at 21.
10. *Id.* at 21–22.
11. *Id.* at 21.
12. *Id.*
13. *Id.* at 1.
14. *Id.* at 29.
15. *Id.* at 31.
16. *Id.* at 23.
17. *Id.*
18. *Id.* at 1.
19. *Id.* at 41.
20. Depository Institutions Deregulation and Monetary Control Act of 1980, Public Law No. 96–221, § 308, 94 Stat. 132, 147 (1980).
21. National Commission Report, *supra* note 2, at 1.
22. *Id.*
23. *Id.* at 1–2.
24. Garn-St. Germain Depository Institutions Act of 1982, Public Law No. 97–330, 96 Stat. 1496 (1982).
25. National Commission Report, *supra* note 2, at 4.
26. *Id.* at 2.
27. *Id.*
28. *Id.* at 44.
29. *Id.* at 2.
30. *Id.* at 5.
31. *Id.* at 3.
32. *Id.*
33. *Id.* at 6.
34. *Id.* at 43.
35. *Id.* at 44.
36. *Id.*
37. Competitive Equality Banking Act, Public Law No. 100–86, Title III, 101 Stat. 552, 585 (1987).
38. Public Law No. 101–73, 103 Stat. 183 (1989).

Chapter **21A**, "Bankruptcy Policies, Restructuring, and Economic Efficiency" (Atiyas)

1. For a review of these policies in a sample of members of the Organization for Economic Cooperation and Development and a detailed discussion of restructuring policies for developing countries, *see* Izak Atiyas, Mark Dutz, & Claudio Frischtak, with Bita Hadjimichael, *Fundamental Issues and Policy Approaches in Industrial Restructuring*, Industry Series Paper No. 56 (1992).
2. A detailed review of the economics of bankruptcy and a comparative analysis of bankruptcy laws in industrialized and industrializing countries is provided in Izak Atiyas, *Bankruptcy Policies, in Regulatory Policies and Reform in Industrializing Countries* (Claudio Frischtak ed., 1995).
3. *See* Douglas Baird & T. H. Jackson, *Cases, Problems and Materials on Bankruptcy* (1985) (Chapter 1 addresses the relation between debt collection and bankruptcy laws).
4. *See, for example,* T. H. Jackson, *The Logic and Limits of Bankruptcy Law* (1986); D.C. Webb, *Does the 1986 Insolvency Act Satisfy the Creditors' Bargain?* (1988)(unpublished paper, London School of Economics); Douglas Baird, *The Uneasy Case for Corporate Reorganizations,* 15 Journal of Legal Studies 127–147 (1986) (undertaking a critical assessment of the role of bankruptcy reorganization in resolving the common pool problem, which has also been called "the race to the courthouse").

5. The literature mentions two basic agency problems: those that arise owing to conflicts of interest between managers and shareholders, and those that arise between owners (or managers) and creditors. The focus here is on the second type of problem.

6. One author has argued that because shareholders of debt-financed firms are interested only in cash flows over and above the repayment of debt—that is, they are only interested in nonbankrupt states—they may forego projects with positive net present values. Stewart Myers, *The Determinants of Corporate Borrowing*, 5 Journal of Financial Economics 147 (1977). Overinvestment rather than underinvestment, especially by increasing the riskiness of investments, is also possible. *See* Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 Journal of Finance 1189 (1991); Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure*, 3 Journal of Financial Economics 305 (1976).

7. Using the terminology in Julian Franks & Walter Torous, *Lessons from a Comparison of the US and UK Insolvency Codes,* 8 Oxford Review of Economic Policy 70 (1992), the rules should tend to avoid premature liquidations, as well as deferred liquidations. In some countries, additional "social" objectives, such as preservation of employment, are also assigned to bankruptcy procedures. This, for example, is an explicit objective of the French legislation.

8. 11 U.S.C. § 1101 *et seq.* (1994).

9. *See* papers reviewed in Atiyas, *supra* note 2.

10. Insolvency Act, 1986, Chapter 45, Parts II and III.

11. *Id.* §§ 13–25.

12. *Id.* § 29(2). An important difference between the administrator and the receiver is that the latter is responsible to the appointor whereas the administrator is responsible to all creditors.

13. The U.S. bankruptcy system is characterized as being "debtor oriented" whereas the U.K. system is more "creditor oriented."

14. Loi no. 85–98 du 25 janvier 1985 relative au redressement et à la liquidation judiciaires des entreprises. Journal Officiel 1097 (Janvier 26, 1985).

15. For a more detailed discussion, *see* Atiyas, *supra* note 2.

Chapter **21B**, "An Explanation of, and Guide to, Business Reorganizations Under Chapter 11 of the U.S. Bankruptcy Code" (Whelan)

1. 11 U.S.C. § 1101 *et seq.* (1994). For ease of explanation, no formal cites will be made in this chapter, other than to certain quoted statutory sections that assist in understanding the context of the chapter. A Chapter 11 bankruptcy case is too complex to be completely covered in the confines of this chapter, and, accordingly, only the more routine areas of bankruptcy law and litigation are summarized herein. This chapter is intended to present a general overview of Chapter 11 and is not intended to constitute legal advice on a given bankruptcy issue.

2. Because of the many complex financial problems that may confront a "person" (such as significant contingent tort claims), the requirement of insolvency, once present under the old Bankruptcy Act, is no longer a requirement under the Bankruptcy Code, which first became effective on October 1, 1979. Certain types of persons—financial institutions, railroads, credit unions, and insurance companies, for example—are dealt with under their own specialized type of liquidation statute, and railroads are also dealt with under a special subchapter of Chapter 11.

3. Because of the delay created by debtors seeking relief under Chapter 11, Congress enacted special "fast-track" provisions applicable solely to single-asset real estate bankruptcies, in which only one asset or project is involved, with usually only one or more secured creditors and few trade creditors, as part of the Bankruptcy Reform Act of 1994, Public Law No 103–394, 108 Stat. 4106 (1994).

4. 11 U.S.C. § 362 (1994). This automatic stay creates a critical mantle of protection for the debtor because its broad application extends to almost any type of action that might affect the debtor or its property—for example, the institution of legal or administrative proceedings to enforce payment of monies, setoffs, perfection of lien rights, protection against cessation of utility service, and any related actions impacting on the administration of the Chapter 11 estate. Upon the filing of this Chapter 11 petition, which creates an estate and

results in the creation of a new legal entity, namely, the "debtor in possession," the debtor is permitted to continue its business operations unfettered by creditor or court oversight.

5. In those cases where the appointment of an individual trustee is not warranted, the court may, if it is in the "best interests of creditors" or if the nontrade debt exceeds $5 million, order the appointment of an examiner whose functions will be limited to an investigation and report with respect to such debtor's business operations.

6. An executory contract, by legal definition, is that type of contract that still requires some form of substantial performance by both parties to the contract. If the only obligation remaining under the provisions of the contract is the obligation of the debtor to repay, such a contract is not deemed to be executory for bankruptcy purposes.

7. The debtor bears the burden of proof in establishing the necessary elements of a preference. If the debtor decides not to pursue such an action because of ongoing business relations with the creditor body, the creditors' committee may apply to the bankruptcy court for authorization to pursue such a cause of action in its own right in order to protect the rights of the unsecured creditor body at large.

8. Such a lien will ordinarily be subordinated to any prior existing liens; however, in extraordinary situations in which the debtor is unable to obtain credit and "adequate protection" can be provided to an existing lien holder, a senior lien may even be obtainable by the debtor. The use of the term "adequate protection" essentially means that the debtor must, in some statutorily provided manner, furnish security for the secured creditor's interest in such property (for example, a replacement lien on other property of like value, cash payments to protect against depreciation, or simply the provision of the "indubitable equivalent" of such protection).

9. General unsecured creditors are, with certain limited exceptions, not entitled to any distributive share of the debtor's estate prior to the effective date of the confirmation of the debtor's plan and are not entitled to the payment of interest beyond the date of the Chapter 11 filing, except in those cases where the debtor is solvent.

10. *See supra* text accompanying note 8.

11. The Bankruptcy Code requires that the stay be lifted, on a motion filed by the secured creditor, whenever "cause" is established (usually meaning that the debtor has failed to furnish some form of adequate protection) or because there is no equity in the property and the property is not necessary for an "effective reorganization."

12. Usually a minimum of 25 days' notice is required prior to conducting a hearing on approval of the disclosure statement, but, once approved, the debtor is afforded an additional 60-day period within which to solicit the statutorily required acceptances to the plan.

13. Analogous to the procedures with respect to approval of the disclosure statement, a 25-day notice period is required prior to commencing the confirmation hearing.

14. Impairment is a special word of art employed in Chapter 11; it signifies that the creditor is having all of its prepetition rights restored or essentially receiving the full benefit of its bargain as entered into prior to bankruptcy.

15. *See supra* text accompanying note 14.

16. In recognition of this problem, Congress created, as part of the Bankruptcy Reform Act of 1994, *supra* note 3, special provisions dealing with small business persons (namely, debtors having aggregate debt of less than $2 million), which greatly simplifies many of the more cumbersome procedural requirements of Chapter 11. At the same time, these provisions provide for a fast-track Chapter 11; for this reason, many debtors will not elect to proceed under the optional small business provisions of the code.

Chapter 21C, "Bankruptcy Law and Bank Insolvency Law in Eastern Europe" (Schiffman)

1. For a more complete analysis of the bankruptcy laws of the Czech Republic, Hungary, and Poland, which includes some of the remarks below, *see* Pamela Bickford Sak & Henry N. Schiffman, ***Bankruptcy Law Reform in Eastern Europe***, 28 The International Lawyer 927 (1994).

2. Act on Bankruptcy and Settlements, No. 328/1991 Coll. of July 11, 1991, as amended, Art. 12(1).

3. *Id.* Art. 12(2).

4. Law IL of 1991 on Bankruptcy Procedures, Liquidation Procedures and Final Settlement (as amended), Nr. IV./19. Hungarian Rules of Law in Force 1225, § 9 (1993).

5. *Id.* § 19(4), (5).
6. *See* Bankruptcy Act, Dziennik Ustaw No. 14, item 87, 1990 (Regulation by the President of the Republic of Poland of October 24, 1934, as amended), Art. 169.
7. *Id.*

Chapter 22A, "The Significance of the International Foreign Exchange Master Agreement" (Emert)

1. The Foreign Exchange Committee & The British Bankers' Association, ***International Foreign Exchange Master Agreement*** (*IFEMA*) (November 1993), ***reprinted herein as*** Appendix II(1).
2. Basle Committee on Banking Supervision, ***Report on International Convergence of Capital Measurement and Capital Standards*** (July 1988, as amended in 1992, 1994, and 1995) [*hereinafter* Basle Capital Accord]. The Basle Capital Accord is reprinted in 1 ***Current Legal Issues Affecting Central Banks*** 487 (Robert C. Effros ed., 1992). The 1992 amendment is reprinted in 3 ***Current Legal Issues Affecting Central Banks*** 296 (Robert C. Effros ed., 1995). Further amendments are reprinted herein as Appendix II(11).
3. The British Bankers' Association & the Foreign Exchange Committee, ***International Currency Options Market (ICOM) Master Agreement and Guide*** (April 1992); ***International Currency Options Market (ICOM) Master Agreement and Guide*** (May 1993). The 1993 ICOM Master Agreement is reprinted herein as Appendix II(2).
4. International Swap Dealers Association, ***ISDA Master Agreement*** (1992), ***reprinted herein as*** Appendix II(3).
5. The British Bankers' Association and the Foreign Exchange Committee are developing (i) the Foreign Exchange and Options Master Agreement (FEOMA), which is a master agreement for spot and forward foreign exchange and foreign exchange options transactions, and (ii) a revised version of the ICOM Master Agreement for foreign exchange options. These agreements should be issued shortly in final form.
6. The Federal Deposit Insurance Corporation Improvement Act, Title IV, Subtitle A, Public Law No. 102–242, 105 Stat. 2236 (1991).
7. *Id.* § 405.
8. 12 Code of Federal Regulations part 231 (1995)(regarding netting eligibility for financial institutions).
9. *Id.* § 231.3.
10. *Id.* § 231.3(a).
11. *Id.* § 231.3(a)(1), (2).
12. *Id.* § 231.2(c).
13. *See* the 1988 version of the Basle Capital Accord, ***supra*** note 2.
14. Basle Capital Accord, ***supra*** note 2.
15. 12 Code of Federal Regulations parts 208 and 225, Appendix A, E(5) (1995).
16. *Id.* at E(5)(2)(ii); Board of Governors of the Federal Reserve System, ***Notice of Financial Rules*** 18 (December 2, 1994).
17. 12 Code of Federal Regulations parts 208 and 225 E(5)(c).
18. *Id.*
19. ***Restatement (Second) of Agency*** § 322 (1958).
20. *Id.* § 321.

Chapter 22B, "An Analysis of the International Foreign Exchange Master Agreement" (Ainslie)

1. The Foreign Exchange Committee & The British Bankers' Association, ***International Foreign Exchange Master Agreement (IFEMA)*** (November 1993), ***reprinted herein as*** Appendix II(1).

2. In 1996, significant revisions were proposed for IFEMA to (i) incorporate more explicitly current market practice in the international foreign exchange markets and to (ii) conform more closely the IFEMA style and reconcile the IFEMA substance to both the ISDA Master Agreement and the ICOM Agreement, each of which is referred to below. Final approval and publication of the revised IFEMA was scheduled for summer 1996. None of the modifications to IFEMA affect the analysis contained herein.

3. International Swap Dealers Association, *ISDA Master Agreement* (1992), *reprinted herein as* Appendix II (3).

4. *FXNET Worldwide Netting and Close-Out Agreement (September 1993).*

5. IFEMA, *supra* note 1.

6. *Id.* § 1.

7. *Id.* § 8.13 and Schedule.

8. *Guidelines for Foreign Exchange Trading Activities of the Foreign Exchange Committee* (revised March 1996).

9. Bank of England, *The London Code of Conduct for Principals and Broking Firms in the Wholesale Markets,* paragraphs 91–99 (July 1995), *reprinted herein as* Appendix II(13).

10. *Hazell v. Hammersmith and Fulham London Borough Council*, 2 Appeal Cases 1 (1992).

11. Basle Committee on Banking Supervision, *Basle Capital Accord: Treatment of Potential Exposure for Off-Balance-Sheet Items* (April 1995) (amending the Basle Accord), *reprinted herein as* Appendix II(11).

12. The British Bankers' Association & the Foreign Exchange Committee, *International Currency Options Market (ICOM) Master Agreement and Guide* (April 1992).

13. The British Bankers' Association & the Foreign Exchange Committee, *International Currency Options Market (ICOM) Master Agreement and Guide* (May 1993). The ICOM Master Agreement is reprinted herein as Appendix II(2).

Chapters **22A–B**, Comment (Bhala)

1. The Foreign Exchange Committee & The British Bankers' Association, *International Foreign Exchange Master Agreement (IFEMA)* (November 1993), *reprinted herein as* Appendix II(1).

2. *FXNET Worldwide Netting and Close-Out Agreement* (September 1993).

3. International Swap Dealers Association, *ISDA Master Agreement* (1992), *reprinted herein as* Appendix II(3).

4. IFEMA, *supra* note 1, § 5.

5. Federal Deposit Insurance Corporation Improvement Act, Title IV, Subtitle A, Public Law No. 102–242, 105 Stat. 2236 (1991).

6. 12 Code of Federal Regulations part 231 (1995)(regarding netting eligibility for financial institutions).

7. Basle Committee on Banking Supervision, *Basle Capital Accord: Treatment of Potential Exposure for Off-Balance-Sheet Items* (April 1995)(amending the text of the Basle Capital Accord), *reprinted herein as* Appendix II(11).

8. The British Bankers' Association & the Foreign Exchange Committee, *International Currency Options Market (ICOM) Master Agreement and Guide* (May 1993). The ICOM Master Agreement is reprinted herein as Appendix II(2).

Chapter **23A**, "Over-the-Counter Derivatives" (Cunningham)

1. *Brane v. Roth,* 590 N.E.2d 587 (Ind. Ct. App. 1992); *In re Compaq Securities Litigation,* No. H-91-9191(S.D. Tex. May 16, 1991).

2. Global Derivatives Study Group, Group of Thirty, *Derivatives: Practices and Principles* 55 (Table 2) (July 1993). The recommendations from the report are reprinted herein as Appendix II(4).

3. *Id.* at 15 (Recommendation 12).

4. Also described as systemic risk. *Id.* at 61.

5. International Swap Derivatives Association, *ISDA Master Agreement* (1992), *reprinted herein* as Appendix II(3). Originally, ISDA stood for the International Swap Dealers Association. In 1994, ISDA changed its name to the International Swap and Derivatives Association, Inc.

6. *Credit Support Annex (New York Law)* (1994).

7. *Derivatives: Practices and Principles, supra* note 2, at 16.

8. *Id.*

9. *Id.*

10. Basle Committee on Banking Supervision, *The Supervisory Treatment of Netting for Capital Adequacy Purposes* (1993). The Basle Capital Accord was amended in 1994. Further amendments are reprinted herein as Appendix II(11).

11. *The Supervisory Treatment of Netting for Capital Adequacy Purposes, supra* note 10, at 1.

12. Basle Committee on Banking Supervision, *Report on International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended in 1992, 1994, and 1995). The Basle Capital Accord is reprinted in 1 *Current Legal Issues Affecting Central Banks* 487 (Robert C. Effros ed., 1992). The 1992 amendment is reprinted in 3 *Current Legal Issues Affecting Central Banks* 296 (Robert C. Effros ed., 1995). Further amendments are reprinted herein as Appendix II(11).

13. Bankruptcy: Swap Agreements and Forward Contracts, Public Law No. 101–311, 104 Stat. 267 (1990)(amending various sections of the Bankruptcy Code, including 11 U.S.C. § 546(g), and inserting 11 U.S.C. § 560).

14. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Public Law No. 101–73, § 212, 103 Stat. 183, 222 (1989).

15. Federal Deposit Insurance Corporation Improvement Act, Title IV, Subtitle A, Public Law No. 102–242, 105 Stat. 2236 (1991).

16. Loi no. 93–1444 du 31 décembre 1993 portant diverses dispositions relatives à la Banque de France, à l'assurance, au crédit et aux marchés financiers [Law No. 93–1444 of December 31, 1993 concerning various measures regarding the Bank of France, insurance, credit, and financial markets], arts. 4, 8, Journal Officiel 231, 232 (Janvier 5, 1994).

17. Bankruptcy and Insolvency Act, Statutes of Canada, Chapter 27, § 30 (1992); Canada Deposit Insurance Corporation Act, Revised Statutes of Canada, Chapter C-3, § 39.15 (1985)(as amended by Chapter 26, § 11 (1992)).

18. Loi du 22 mars 1993, Art. 157; *see Legal Opinions on the Enforceability of the Termination and Close-Out Netting Provisions of the 1992 ISDA Master Agreements* (May 1994).

19. Insolvenzordnung vom 5. Oktober 1994, § 104, Bundesgesetzblatt I S. 2866.

20. Schuldbetreibung und Konkurs vom 16 Dezember 1994 der aun 1 Janvar 1997 [Swiss Federal Bankruptcy Code adopted on December 16, 1994, effective as of January 1, 1997], Art. 211 *bis*.

21. New York Banking Law § 618–a (Consolidated Laws Service 1994).

Chapter 23B, "The Risks of Financial Derivatives" (Raisler)

1. Global Derivatives Study Group, Group of Thirty, *Derivatives: Practices and Principles* 43–52 (July 1993). The recommendations from the report are reprinted herein as Appendix II(4).

2. *Id.* at 9 (Recommendation 1).

3. *Id.*

4. *Hazell v. Hammersmith and Fulham London Borough Council*, 2 Appeal Cases 1 (1992).

5. Futures Trading Practices Act of 1992, Public Law No. 102-546, 106 Stat. 3590 (1992).

6. Exemption of Swap Agreements, 17 Code of Federal Regulations § 35 (1995).

7. *Derivatives: Practices and Principles, supra* note 1, Appendix II, at 8 (note 15) (citing *Carragreen Currency Corporation Pty Limited v. Corporate Affairs Commission*).

8. *Derivatives: Practices and Principles, supra* note 1, Appendix II.

9. *Derivatives: Practices and Principles, supra* note 1, at 23 (Recommendation 22).

10. *Id.* at 15 (Recommendation 12).

11. *See* Kenneth N. Gilpin, *Founder of Askin Capital Agrees to Settlement of S.E.C. Charges*, N.Y. Times, May 24, 1995, at D8.

12. U.S. General Accounting Office, *Financial Derivatives: Actions Needed to Protect the Financial System*, GAO/GGD-94-133 (May 1994).

13. *Derivatives: Practices and Principles, supra* note 1, Appendix I, at 132.

14. *Derivatives: Practices and Principles, supra* note 1, at 51.

Chapters **23A–B**, Comment (Folkerts-Landau)

1. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Public Law No. 101–73, 103 Stat. 183 (1989).

2. Bankruptcy: Swap Agreements and Forward Contracts, Public Law No. 101–311, 104 Stat. 267 (1990)(amending various sections of the Bankruptcy Code, including 11 U.S.C. § 546, and inserting 11 U.S.C. § 560).

3. Federal Deposit Insurance Corporation Improvement Act, Title IV, Subtitle A, Public Law No. 102–242, 105 Stat. 2236 (1991).

Chapter **24**, "Securitization: Has It Matured?" (Welshimer)

1. Mortgage-backed securities (MBSs), asset-backed securities (ABSs), collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), interest-only certificates (IOs), principal-only certificates (POs), and planned amortization classes (PACs).

2. Loi no. 88–1201 relative aux organismes de placement collectif en valeurs mobiliéres et portant création des fonds communs de créances (December 23, 1988).

3. Depository Institutions Deregulation Act of 1980, Public Law No. 96–221, Title II, 94 Stat. 142–145 (1980)(current version at 12 U.S.C. § 3501 to 3508 and 3509 note).

4. The Government National Mortgage Association guarantees the timely receipt of all principal and interest payments due on the underlying pool of mortgage loans. This guarantee is backed by the full faith and credit of the United States. In contrast, the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) purchase portfolios of mortgage loans and repackage them in the form of securities. FNMA mortgage-backed securities are guaranteed as to timely payment of interest and principal, whereas their FHLMC counterparts are guaranteed as to timely payment of interest and ultimate payment of principal; however, the obligations of FNMA and FHLMC are backed solely by their corporate assets, rather than the full faith and credit of the United States.

5. Secondary Mortgage Market Enhancement Act of 1984, Public Law No. 98–440, 98 Stat. 1689 (1984).

6. Tax Reform Act of 1986, Public Law No. 99–514, Title VI, Subtitle H, 100 Stat. 2308 (1986)[hereinafter REMIC](codified at 26 U.S.C. § 860A *et seq.*).

7. 12 U.S.C. § 860A(a) (1994). Prior to the REMIC legislation, *supra* note 6, a number of multiclass CMOs were issued in the form of debt by owner trusts that were treated as partnerships for federal income tax purposes. However, these vehicles were substantially less flexible than the transactions ultimately made possible by the REMIC legislation.

8. 12 Code of Federal Regulations § 204.2 (1995).

9. *Id.* § 204.2(a)(2)(ix).

10. 12 Code of Federal Regulations part 217 (1995).

11. Accordingly, a description of asset-backed commercial paper programs, structured preferred stock financings, pay-through debt issued by special-purpose, bankruptcy-remote corporations, and many other structures tailored to the particular needs of the parties involved is omitted.

12. Many countries do not have a common law "trust" concept similar to that in the United States. A trust, simply described, entails the transfer of record ownership of an asset to a "trustee" who holds record title for the benefit of designated "beneficiaries" (in the case of securitizations, the certificate holders). The trustee, in addition to holding record title to the assets, periodically receives and passes through to investors the cash flow generated by the assets.

13. REMIC, *supra* note 6.

14. *See infra* the section entitled "Banking Regulations and Related Capital Treatment."

15. 17 Code of Federal Regulations § 270.3a-7 (1995); Investment Company Act of 1940, Chapter 686, Title I, 54 Stat. 789 (1940)(codified at 15 U.S.C. § 80a-1 to 80a-52).

16. 12 U.S.C. § 860A(a) (1994).

17. Basle Committee on Banking Supervision, *Report on International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended in 1992, 1994, and 1995). The Basle Capital Accord is reprinted in 1 *Current Legal Issues Affecting Central Banks* 487 (Robert C. Effros ed., 1992). The 1992 amendment is reprinted in 3 *Current Legal Issues Affecting Central Banks* 296 (Robert C. Effros ed., 1995). Further amendments are reprinted herein as Appendix II(11).

18. Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 77: Reporting by Transferors for Transfers of Receivables with Recourse* (1983), *reprinted in Securitization* Appendix B (Ronald S. Borod ed., 1994).

19. *Id.* para. 5.

20. Direct credit enhancement includes, for example, provision of a direct guarantee or retention of a subordinate interest; indirect credit enhancement includes providing some protection or recourse to a third-party credit enhancer—an unaffiliated bank that writes a letter of credit or funds a cash collateral account, for example—that, in turn, because of its ability to analyze the assets more thoroughly than capital market investors, is willing to provide a greater degree of protection to the security holders themselves. An example is a circumstance in which a $100*x* pool of assets is securitized, and an unaffiliated bank writes a letter of credit or funds a cash collateral account for $10*x*, but that credit enhancer, in turn, is protected by only $3x of direct or indirect recourse to the seller.

21. 59 Federal Register 27116 (1994)(proposing amendments to 12 Code of Federal Regulations parts 3, 208, 225, 325, and 567); *see* 60 Federal Register 8177, 15858, and 17986 (1995)(final rules).

22. 59 Federal Register 27123 (1994).

23. *Id.* at 27124.

24. *Id.*

25. *See supra* note 15.

26. 15 U.S.C. § 80a-3 (1994).

27. *Id.*

28. 17 Code of Federal Regulations § 270.3a-7 (1995).

29. *Id.*

30. REMIC, *supra* note 6.

31. *See supra* note 21.

32. *See supra* note 28.

Chapter 24, Comment (Rocks)

1. 11 U.S.C. § 362 (1994).
2. *Id.* §§ 544, 547, 548.
3. *Id.* § 547(b).
4. *Id.* § 547(c)(1)(A).
5. *Id.* § 548(a)(2).
6. *Id.* § 548.
7. 12 U.S.C. §§ 21 *et seq.* (1994).
8. *Id.* §§ 1811 *et seq.*
9. Standard & Poor's, ***International Structured Finance***, Credit Review (March 29, 1993). This publication considers the subject in Australia, France, Japan, Spain, Sweden, and the United Kingdom. Issues facing potential securitizations in Ireland and New Zealand are also addressed.
10. Basle Committee on Banking Supervision, ***Report on International Convergence of Capital Measurement and Capital Standards*** (July 1988, as amended in 1992, 1994, and 1995). The Basle Capital Accord is reprinted in 1 ***Current Legal Issues Affecting Central Banks*** 487 (Robert C. Effros ed., 1992). The 1992 amendment is reprinted in 3 ***Current Legal Issues Affecting Central Banks*** 296 (Robert C. Effros ed., 1995). Further amendments are reprinted herein as Appendix II(11).
11. Law Concerning Regulation of Business Pertaining to Specified Credit, Law No. 77 (1992).

Chapter 25A, "Legal Issues Regarding Payment and Netting Systems" (Giovanoli)

1. This is an extensively revised version (notably with a new section describing the origin of netting schemes) of Chapter 9 (drafted by Mario Giovanoli) of ***Cross-Border Electronic Banking*** (Joseph J. Norton *et al.* eds., 1995).
2. *See* Working Group on European Community Payment Systems, ***Minimum Common Features for Domestic Payment Systems*** Annex 2 (Glossary), at 5 (November 1993) (taken over from the glossary of the EC Blue Book (September 1992)). It should, however, be borne in mind that netting can in certain circumstances also result from statutory provisions and thus is not necessarily exclusively based on contractual arrangements.
3. Hence, the designations "bank money" in English, "***Buchgeld***" (book-entry money) in German, or "***monnaie scripturale***" (account money) in French.
4. Banknotes and central bank balances together are referred to as "central bank money."
5. In this connection, *see* Mario Giovanoli, ***Bargeld - Buchgeld - Zentralbankgeld: Einheit oder Vielfalt im Geldbegriff*** 87–124 (1993)(containing many references).
6. With both forms of money, cash and noncash, three elements have to be carefully distinguished: (i) the monetary unit (the "container"), which is a unit of measurement; (ii) the monetary asset or means of payment (the "contents"), which is the value transferred (the ownership of coins or banknotes in the case of cash and a monetary claim against a bank in the case of cashless payments); and (iii) the means of transferring the monetary asset (the "vehicle"). Thus, except in the case of genuine electronic cash, such as certain electronic purse devices or e-cash (cybercurrency), the expression "electronic money" is misleading, as only the vehicle is electronic (for example, a debit card or telebanking) while the monetary asset made available to the beneficiary of the cashless payment is a claim against his bank.
7. *See* Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries, ***Payment Systems in the Group of Ten Countries*** (4th ed. December 1993).
8. Cashless "payments" comprise credit transfers (in the strict meaning of the term) and debit collections, where the initiative for the payment procedure is taken by the creditor on

the basis of an authorization granted by the debtor. (This is often the case for credit cards and bank checks.) However, in all cases, the cashless payment eventually provides the creditor with an account entry in the form of a credit with his bank.

9. Despite the designation "credit transfer," there is neither a transfer nor any assignment of a claim from the legal point of view. In reality, on the basis of a payment order received directly or indirectly from the debtor-originator, the beneficiary's bank provides an unconditional credit to the beneficiary on his account. In other words, the beneficiary's bank incurs a new obligation toward the beneficiary in the amount of the credit "transfer." Simultaneously, and in consideration of the credit so provided to the beneficiary, the beneficiary's bank is discharged of a liability in the same amount by receiving a credit from or by debiting the account of the originator, the originator's bank, or an intermediary bank.

10. In its simplest form, the in-house transfer (where the originator and the beneficiary have accounts with the same bank), a single payment transaction involves three participants. More often, at least two banks are involved, as the originator and the beneficiary of the payment hold accounts with different banks. (*See* Figure 1.) Furthermore, as these two banks do not necessarily have a direct account relationship with one another, one or more further (intermediary) banks may intervene in the payment procedure.

11. The specific banking contract by which a bank undertakes to effect and receive credit transfers for an account holder (a bank customer or another bank) is known in French as ***contrat de giro bancaire*** (a credit transfer is referred to as a ***virement***); in German, the contract is known as ***Überweisungsvertrag***.

12. In German, this chain is known as ***Deckungsverhältnis.***

13. In German, the underlying obligation is known as ***Valutaverhältnis.***

14. It should be noted that the payment process is not necessarily linked to an underlying obligation, as in some cases in which a depositor may simply wish to transfer funds from one bank to an account that is held with another bank.

15. ***See infra*** the section entitled "Origin of Payments Netting."

16. ***See*** C.E.V. Borio & P. Van den Bergh, ***The Nature and Management of Payment System Risks: An International Perspective***, BIS Economic Papers No. 36 (February 1993).

17. In so-called one-tier systems, all or most credit and financial institutions take part directly in the payment system, while access to two-tier systems is limited to a more or less restricted circle of clearing banks, through which smaller institutions settle on their own behalf or on behalf of their customers.

18. Etymologically, the word ***netting*** (from ***net***, as opposed to ***gross***) has nothing to do with ***network***, although the concept of a multilateral netting scheme might suggest the analogy. Indeed, ***net*** (***Netto*** in German, derived from Italian) originates in the Latin ***nitidus*** (brilliant, neat, clear, as opposed to ***brutus***, rough (in German, ***Brutto***; in French, ***brut***). In contrast, ***network*** and ***fishing net*** are akin to the German words ***Netz*** (fishing net) and ***nähen*** (to sew), as well as to the English word ***needle*** and to the Latin terms ***nere*** (to spin (declension omitted)) and ***neta*** (cloth, texture).

19. ***See*** Fernand Braudel, 2 ***Civilisation matérielle, économie et capitalisme, XVe-XVIIIe siècle, Les jeux de l'échange*** 72, 87 (1879) (stating "***Les foires sont, en effet, une confrontation de dettes qui, se détruisant les unes les autres, fondent comme neige au soleil: ce sont les merveilles du*** scontro, ***de la compensation***" and "... ***on retrouve à Londres, avec un peu de retard, les mêmes pratiques qu'en Hollande, y compris les*** Rescounters days—***mot calqué directement sur les*** Rescontre-Dagen ***d'Amsterdam***").

20. ***See*** Gustav Neuhaus, ***Die Skontration, ihre historische Entwicklung, juristische Natur u. volkswirtschaftliche Bedeutung***, thesis Erlangen, Dar-es-Salaam 13 (1892). This requirement aims at ensuring that the participant is able to settle his final net-net balance.

21. For a lively presentation of this development in comic style, ***see*** Federal Reserve Bank of New York, ***The Story of Checks and Electronic Payments*** 5–7 (1987). For a precise descrip-

tion of the traditional mechanism of the London Clearing House, *see* Stanley Jevons, ***Money and the Mechanism of Exchange*** 255 *et seq*., 263 *et seq*. (1875).

22. According to Jevons, ***supra note*** 21, at 265 and 267 *et seq*., this development took place chiefly as a result of the efforts of Sir John Lubbock.

23. Maurice Roche-Agussol, ***Essai sur le "Clearing System"*** 60 *et seq*. (1903)(thesis, Montpellier); W. Endemann, 3 ***Handbuch des deutschen Handels-, See- und Wechselrechts*** 1056 *et seq*. (1885); *see* Jevons, ***supra*** note 21, at 279–282.

24. Unless there are direct or indirect (through correspondent banks) account relations between the banks concerned.

25. Marc Hollanders, ***The Role of Central Banks in Payment Systems,*** Revue de la Banque/Banken Financiewezen 23, 24 (1994). Furthermore, the structure and functioning of payment systems can affect the volume and velocity of money circulation (in particular with regard to central bank money), which effects must therefore be taken into account in defining targets for monetary policy purposes. The various types of payment arrangements, while they may appear to influence the details of money market operations, need not strictly determine the selection of the monetary instruments themselves.

26. In this connection, *see* Bank for International Settlements, ***64th Annual Report*** Chapter VIII, 172–192 (Payment and Settlement Systems: Trends and Risk Management)(June 13, 1994). In many countries, the task of supervising the capital adequacy treatment of banks as participants in payment systems and the task of overseeing those very payment systems fall to different authorities.

27. *See* Bank for International Settlements, ***Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries*** (the Lamfalussy Report) at paragraphs (Part A) 3.7 to 3.10, (Part D) 1.1 to 5.1 (November 1990).

28. From another perspective, it is possible to distinguish between payment systems according to whether (i) the participating banks act as agents for customers or as principals, (ii) the payment instructions take the form of debit or credit messages, or (iii) the payments are processed in real time, on a same-day basis, or according to a multiday cycle.

29. Finality refers here to the credit transfer included in the settlement system and not to the underlying obligation. *See* ***supra*** notes 12–14 and accompanying text.

30. If a central bank operates RTGS accounts, it may choose to extend additional intraday liquidity to the settlement banks (through an overdraft facility or via sale and repurchase agreements), in order to promote the timely processing of payment instructions and to avoid situations of gridlock.

31. "Payment process" as used here refers to the chain of credit transfers channeled through bank accounts (to extinguish the underlying obligations) and not to the underlying obligations themselves.

32. Multilateral netting can occur in two ways: by direct determination of multilateral net positions or indirectly by netting the net bilateral positions and thus obtaining net-net positions.

33. The payment orders (relating to credit transfers) comprised in the netting process should not be confused with the underlying obligations, which are, of course, not netted and will be extinguished only upon completion of all the credit transfers in the chain, only a segment of which is ordinarily included in the net payment system.

34. In other words, the netting is effective subject to the condition (which is either suspensive or resolutory) that the settlement of the net positions occurs.

35. While typical, unwinding is not a necessary solution. A net creditor could simply not be paid in full upon nonsettlement. Deletion of payments is done by choice.

36. Some new systems are built on bilateral netting arrangements, which, although less efficient in terms of liquidity, are considered to be safer from the legal point of view.

37. This is obvious in over-the-counter transactions.

38. The central counterparty interposes itself by way of substitution between two participants *X* and *Y*. Each transaction is thus cut into two matching operations, the first between participant *X* and the central counterparty, and the second between the central counterparty and participant *Y*.

39. For example, the Public Securities Association (PSA), IFEMA, and ISDA Master Agreements. The latter two are reprinted herein as Appendices II(1) and II(3), respectively.

40. The recognition of netting arrangements was initially restricted to the so-called netting by novation in the 1988 Basle Capital Accord, but it was successively extended to other forms of bilateral netting in July 1994 and April 1995. *See* Basle Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended in 1992, 1994, and 1995) [hereinafter Basle Capital Accord]. The Basle Capital Accord is reprinted in 1 *Current Legal Issues Affecting Central Banks* 487 (Robert C. Effros ed., 1992). The 1992 amendment is reprinted in 3 *Current Legal Issues Affecting Central Banks* 296 (Robert C. Effros ed., 1995). Further amendments are reprinted herein as Appendix II(11); *see infra* the section entitled "International Initiatives Under the Auspices of the Group of Ten Central Banks and the Basle Committee on Banking Supervision," note 52, and the accompanying text.

41. Payments need not necessarily relate to an underlying obligation, as they may be caused, for example, by an account holder transferring amounts between two of his own accounts.

42. Bilateral and multilateral netting may also be combined in a settlement system to ensure settlement on the basis of bilateral net positions, as a legally binding fallback position, in the event of failure to settle multilateral net positions. This interesting solution has in particular been adopted within the London-based Clearing House Automated Payments System (CHAPS) network.

43. This rule consequently renders void any setoff of payments (in a net settlement system) or any payment (in a gross settlement system) effected on the day of the bankruptcy judgment, in the hours preceding the judgment).

44. This mechanism is known in German law as *Skontration.*

45. The Clearing House Interbank Payments System is a private clearing system based in New York that mostly handles internationally related transfers, such as foreign exchange and Eurodollar transactions.

46. *See supra* the section entitled "Gross Settlement Systems" and the definition of gridlock risk in the section entitled "Risks Involved in Payment Systems."

47. Such a "circles-processing facility" does not strictly speaking undertake netting, but rather the simultaneous settlement of gross payments in situations in which liquidity is insufficient to allow individual settlements. Any such prenetting can, of course, only increase the security of a gross payment system to the extent that its enforceability in law is beyond any doubt; otherwise, the result could well prove more dangerous than the initial risk.

48. *See* The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Public Law No. 101–73, § 212, 103 Stat. 183 (1989)(amending 12 U.S.C. § 1821); Bankruptcy: Swap Agreements and Forward Contracts Act, Public Law No. 101–311, § 101 *et seq.*, 104 Stat. 267 (1990)(amending scattered sections of 11 U.S.C.); Federal Deposit Insurance Corporation Improvement Act of 1991, Public Law No. 102–242, § 401 *et seq.*, 105 Stat. 2236 (1991).

49. N.Y. Banking Law §§ 615, 618-a, 619 (as amended, 1995).

50. For further information regarding this legislation, *see* Financial Markets Lawyers Group, *Legal Opinions on the Enforceability of the Termination and Close-Out Netting Provisions of the IFEMA* (December 1995); *Legal Opinions on the Enforceability of the Termination and Close-Out Netting Provisions of the 1992 ISDA Master Agreements* (May 1994).

51. For an overview of the various international initiatives in this field, *see* Gregor C. Heinrich, *Funds Transfers, Payments, and Payment Systems—International Initiatives Towards Legal Harmonisation*, Chapter 10 of *Cross-Border Electronic Banking*, *supra* note 1. This chapter was also published in 28 International Lawyer 787 (1994).

52. *International Convergence of Capital Measurement and Capital Standards, supra* note 40, Annex 3.

53. *Id.* note 6.

54. The text of the amendment is included in Annex 1 of the *Basle Capital Accord: The Treatment of the Credit Risk Associated with Certain Off-Balance-Sheet Items* (July 1994) and in the Annex of *Basle Capital Accord: Treatment of Potential Exposure for Off-Balance-Sheet Items* (April 1995). The latter amendment, which incorporates the July 1994 amendment, is reprinted herein as Appendix II(11).

55. *See Basle Capital Accord: Treatment of Potential Exposure for Off-Balance-Sheet Items, supra* note 54, at Annex, note 6.

56. *Minimum Common Features for Domestic Payment Systems, supra* note 2, at 5.

57. Working Group on EU Payment Systems, *Report to the Council of the EMI on the TARGET System* (adopted by the EMI Council in March 1995).

58. *See, in particular*, Amended Proposal for a European Parliament and Council Directive on EU Credit Transfers, COM(95) 264 final, of 7 June 1995, 1995 Official Journal of the European Communities [O.J.] (C 199) 16; Xavier Favre-Bulle, *La politique communautaire dans le domaine des systèmes de paiement, Quelle protection pour les utilisateurs?* AJP/PJA 319–329 (March 1994)(containing many references). The aims of the above-mentioned Proposed Directive on Cross-Border Credit Transfers are to promote more competition in the making of credit transfers and to reduce the costs and time taken, whatever the currency.

59. Although there has been no official publication of this text to date, an excerpt was published in Institutions Européennes & Finances, No. 26, at 2–3 (July/August 1995).

60. *See* Amended Proposal for a Council Directive Concerning the Reorganization and Winding-Up of Credit Institutions and Deposit-Guarantee Schemes, COM(88) 4 final, 1988 O.J. (C 36) 1.

61. *See* Amended Proposal for a European Parliament and Council Directive Amending Council Directives 89/647/EEC and 93/6/EEC with Respect to the Supervisory Recognition of Contracts for Novation and Netting Agreements ('Contractual Netting'), COM(95) 170 final, 1995 O.J. (C 165) 6; Common Position (EC) No. 21/95 Adopted by the Council on 5 September 1995 with a View to the Adoption of Directive 95/.../EC of the European Parliament and of the Council of ... Amending Directive 89/647/EEC as Regards Recognition of Contractual Netting by the Competent Authorities, 1995 O.J. (C 288) 30.

62. *See* Marc Dassesse, *Les quiproquos du netting*, Revue de Droit Bancaire et de la Bourse, No. 49, 107 (May/June 1995); Marc Dassesse, *Netting at Risk? Implications for the Validity of Netting Agreements of the EC Draft Bankruptcy Convention and of the EC Draft Directive on the Winding-up of Credit Institutions*, Butterworths Journal of International Banking and Financial Law 18–24 (January 1995).

63. These different laws (in particular, private law rules and bankruptcy laws) may be subject to different conflict of laws rules.

64. The impact of electronic data interchange (EDI) should also be studied further in order to avoid incompatibilities among national rules: the current UNCITRAL initiative in this field will no doubt prove to be useful.

65. These minimum standards would build upon the recent and encouraging legislative developments in various countries in this regard.

66. *See supra* note 61 and accompanying text.

Chapter 25B, "Risks in the Large-Value Payment System and the Role of Netting" (Cohen)

1. *See* Omnibus Budget Reconciliation Act of 1993, Public Law No. 103-66, § 3001, 107 Stat. 31 (1993). Section 3001(a) is set forth in note 20 of Chapter 11B.

2. Bank for International Settlements, ***Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries*** (November 1990).

3. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Public Law No. 101-73, § 212, 103 Stat. 183, 222 (1989).

4. Bankruptcy: Swap Agreements and Forward Contracts, Public Law No. 101-311, 104 Stat. 267 (1990)(amending various sections of the Bankruptcy Code, including 11 U.S.C. § 546, and inserting 11 U.S.C. § 560).

5. Federal Deposit Insurance Corporation Improvement Act, Title IV, Subtitle A, Public Law No. 102-242, 105 Stat. 2236 (1991) [hereinafter FDICIA].

6. *See generally* Joseph D. Becker, ***International Insolvency: The Case of Herstatt,*** 62 American Bar Association Journal 1290 (1976).

7. FDICIA, ***supra*** note 5.

8. ***Id.*** § 403.

9. ***Id.*** § 402(9).

10. ***Id.*** (providing "or any other institution as determined by the Board of Governors of the Federal Reserve System").

11. 59 Federal Register 4780 (1994).

12. Basle Committee on Banking Supervision, ***Report of the Basle Committee on International Convergence of Capital Measurement and Capital Standards*** (July 1988, as amended in 1992, 1994, and 1995) [hereinafter Basle Capital Accord]. The Basle Capital Accord is reprinted in 1 ***Current Legal Issues Affecting Central Banks*** 487 (Robert C. Effros ed., 1992). The 1992 amendment is reprinted in 3 ***Current Legal Issues Affecting Central Banks*** 296 (Robert C. Effros ed., 1995). Further amendments are reprinted herein as Appendix II(11).

13. Rules 2 and 13(k) provide:

> 2. Storage and Release of Payment Messages
>
> A payment message may be stored in the System by a Participant. At any time prior to being released, a stored payment message may be deleted by the Participant. After a payment message has been released by a Sending Participant, it cannot be deleted by the Sending Participant and is deemed to have been received by the Receiving Participant. The release of a payment message creates an obligation of the Sending Participant to pay the Receiving Participant the amount of the payment message. The obligation of the Sending Participant to pay the Receiving Participant is to be netted in accordance with Rule 12 and settled in accordance with Rule 13 and, except pursuant to the last sentence of this Rule 2, is not excused for any reason, including, without limitation, a rejection, cancellation, amendment, or revocation of the instruction in the payment message. If the System fails to complete settlement pursuant to Rule 13, the payment message shall be returned to storage, in which event the obligation of the Sending Participant to pay the Receiving Participant is excused, and the discharge and payment provided for by the netting under Rule 12 shall be deemed not to have occurred.
>
> . . .
>
> 13(k). Clearing House Committee Action.
>
> If settlement is not completed after the procedures described above have been followed, the Clearing House Committee, after consultation with such parties as it deems appropriate, shall have the authority to take such action as it deems appropriate, but, in any event, may not impose on any Participant any liability in excess of that otherwise provided by these Rules. The Clearing House Committee shall place primary emphasis on completing settlement, but may

declare that the System has failed to complete settlement pursuant to its Rules, and, in that event, all payment messages shall be returned to storage as referred to in the last sentence of Rule 2.

New York Clearing House Association, *CHIPS Rules and Administrative Procedures Rules* 2, 11 (1993).

Chapters **25A–B**, Comment (Hook)

1. The Group of Ten countries are Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.
2. Federal Deposit Insurance Corporation Improvement Act, Title IV, Subtitle A, Public Law No. 102-242, 105 Stat. 2236 (1991); Bankruptcy: Swap Agreements and Forward Contracts, Public Law No. 101-311, 104 Stat. 267 (1990)(amending various sections of the Bankruptcy Code, including 11 U.S.C. § 546, and inserting 11 U.S.C. § 560); The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Public Law No. 101-73, § 212, 103 Stat. 183, 222 (1989).

Chapter **26A**, "Delivery Against Payment" (Patrikis)

1. The terms "seller" and "buyer" are very simple terms. The seller really could be the securities broker-dealer of the seller, and the buyer could be the securities broker-dealer of the buyer, the buyer's bank, or the buyer's dealer's bank. In this chapter, the simple terms "buyer" and "seller" are used to encompass these possibilities, as may be appropriate to the context.
2. Committee on Payment and Settlement Systems of the Central Bank Group of Ten Countries, *Delivery Versus Payment in Securities Settlement Systems* 4 (September 1992).

Chapter **26B**, "Legal Issues Regarding Payment and Settlement" (Fisher)

1. Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries, *Delivery Versus Payment in Securities Settlement Systems* (September 1992).
2. Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries, *Cross-Border Securities Settlement* (March 1995).
3. *Id.* at 47.
4. Group of Thirty, *Clearance and Settlement Systems in the World's Securities Markets* (March 1989).
5. *Cross-Border Securities Settlement*, *supra* note 2, at 17.

Chapter **26C**, "Securities Clearance and Settlement" (Lorne)

1. *See* Securities Review Committee, *The Operation and Regulation of the Hong Kong Securities Industry* 100–05, 154, 349–54 (May 1988).
2. *See The Issues Surrounding the Collapse of Drexel Burnham Lambert: Hearings Before the Senate Comm. on Banking, House & Urban Affairs,* 101st Congress, 2d Session 43–53 (1990) (statement of Richard C. Breeden, Chairman, SEC). The SEC approved a rule to allow The Depository Trust Company to play this role of "honest broker." *See* Securities Exchange Act Release No. 32,759, 58 Federal Register 44865 (1993).
3. Group of Thirty, *Clearance and Settlement Systems in the World's Securities Markets* (March 1989).
4. Bachmann Task Force, *Report of the Bachmann Task Force on Clearance and Settlement Reform in U.S. Securities Markets* 35 (May 1992).
5. *See* Securities Transaction Settlement, Securities Exchange Act Release No. 33,023, 58 Federal Register 52891 (1993).
6. *Id.*; Securities Exchange Act Release No. 342952, 59 Federal Register 59137 (1994)(providing that the rule was to enter into effect June 7, 1995); *see also* Securities

Transactions Settlement, 60 Federal Register 30906 (1995)(providing an exemption from the rule for transactions involving certain insurance contracts).

7. Securities Exchange Act Release No. 33,023, *supra* note 5.

8. *See* American Law Institute and the National Conference of Commissioners on Uniform State Laws, *Uniform Commercial Code Revised Article 8. Investment Securities (With Amendments to Article 9. Secured Transactions)* (1994). The revised Article 8 of the Uniform Commerical Code was adopted in 1995.

Chapters 26A–C, Comment (Mooney)

1. American Law Institute & the National Conference of Commissioners on Uniform State Laws, *Uniform Commercial Code Revised Article 8. Investment Securities (With Amendments to Article 9. Secured Transactions)* (1994). The revised Article 8 of the Uniform Commerical code was adopted in 1995.

2. *Id.*

Chapter 27, "International Banking Capital Standards for Market Risk: Recent Developments and Possible New Directions" (Houpt)

1. Basle Committee on Banking Supervision, *Report on International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended in 1992, 1994, and 1995) [hereinafter Basle Capital Accord]. The Basle Capital Accord is reprinted in 1 *Current Legal Issues Affecting Central Banks* 487 (Robert C. Effros ed., 1992). The 1992 amendment is reprinted in 3 *Current Legal Issues Affecting Central Banks* 296 (Robert C. Effros ed., 1995). Further amendments are reprinted herein as Appendix II(11).

2. Council Directive 93/6 of 15 March 1993 on the Capital Adequacy of Investment Firms and Credit Institutions, 1993 Official Journal of the European Communities (L 141) 1 [hereinafter Capital Adequacy Directive], *reprinted in* 3 *Current Legal Issues Affecting Central Banks*, *supra* note 1, at 497.

3. Basle Committee on Banking Supervision, *The Supervisory Treatment of Market Risks* (April 1993); *see also* Basle Committee on Banking Supervision, *Planned Supplement to the Capital Accord to Incorporate Market Risks* (April 1995); Basle Committee on Banking Supervision, *An Internal Model-Based Approach to Market Risk Capital Requirements* (April 1995).

4. *The Supervisory Treatment of Market Risks, supra* note 3. The proposed measure for foreign exchange risk covers nontrading exposures as well, including those resulting from accrued income and expenses that are denominated in foreign currencies.

5. Basle Capital Accord, *supra* note 1, Annex 3.

6. Notional amounts are reference values used to calculate payments between parties. For example, a 10 percent payment on a notional value of $1 million would be $100,000.

In July 1994, the Basle Committee on Banking Supervision proposal to expand the range of conversion factors used to calculate potential future exposure was issued for public comment. The new proposed factors would apply to commodity and equity contracts and to transactions having maturities beyond five years. The factor would be as high as 15 percent of notional values in the case of long-dated commodities contracts. Basle Committee on Banking Supervision, *Basle Capital Accord: The Treatment of the Credit Risk Associated with Certain Off-Balance-Sheet Items* Annex 3 (July 1994).

7. At this time, the Committee believes that is premature to recognize the potential benefits of multilateral netting because the operational requirements of such netting procedures have not yet been fully analyzed.

8. Basle Committee on Banking Supervision, *The Supervisory Recognition of Netting for Capital Adequacy Purposes* Annex 2 (April 1993).

9. Federal Deposit Insurance Corporation Improvement Act of 1991, Title IV, Subtitle A, Public Law No. 102–242, 105 Stat. 2236 (1991).

10. *Basle Capital Accord: The Treatment of the Credit Risk Associated with Certain Off-Balance-Sheet Items, supra* note 6.

11. *Id.* at 3.

12. Capital Adequacy Directive, *supra* note 2.

13. A one-tail test is used to calculate the likelihood that losses (or gains) exceed a certain percentage. In contrast, a two-tail test analyzes the likelihood that both losses and gains exceed a certain percentage. *See* Russell Davidson & James G. MacKinnon, *Estimation and Inference in Econometrics* (1993).

14. Fat tails refer to the higher likelihood of extreme events under the true underlying distribution of returns than under the normal distribution. *See id.* at 62–63.

15. Basle Committee on Banking Supervision, *Risk Management Guidelines for Derivatives* (July 1994), *reprinted in part herein* as Appendix II(6).

16. Basle Committee on Banking Supervision, *Amendment to the Capital Accord to Incorporate Market Risks* (January 1996).

17. Capital Adequacy Directive, *supra* note 2.

Chapter 27, Comment (Bettauer)

1. Basle Committee on Banking Supervision, *The Supervisory Recognition of Netting for Capital Adequacy Purposes* (April 1993); *see also Basle Capital Accord: The Treatment of the Credit Risk Associated with Certain Off-Balance-Sheet Items* (July 1994).

2. For final OCC rules, *see* 59 Federal Register 66645 (1994)(codified at 12 Code of Federal Regulations Parts 3 and 567).

3. *The Supervisory Recognition of Netting for Capital Adequacy Purposes, supra* note 1, Annex 2. A walkaway clause has been defined in 59 Federal Register 26456, 26458 (1994) as follows:

> A walkaway clause is a provision in a netting contract that permits the non-defaulting counterparty to make only limited payments, or no payments at all, to the defaulter or the estate of the defaulter even if the defaulter is a net creditor under the contract.

4. Comptroller of the Currency, *Banking Circular No. 277: Risk Management of Financial Derivatives* (October 27, 1993). Excerpts of this circular are reprinted herein as Appendix II(7).

5. OCC Bulletin 94-31, Questions and Answers about BC-277 (May 1994). Subsequently, the OCC has also issued additional guidance in the form of a pamphlet on risk management of derivatives, Comptroller of the Currency, *Risk Management of Financial Derivatives: Comptroller's Handbook* (October 1994).

6. Basle Committee on Banking Supervision, *Risk Management Guidelines for Derivatives* (July 1994), *reprinted in part herein* as Appendix II(6); *see also* Basle Committee on Banking Supervision, *Prudential Supervision of Banks' Derivatives Activities* (December 1994).

Biographical Sketches

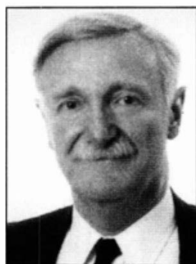
Biographical Sketches

EDITOR

Robert C. Effros received his undergraduate degree from Harvard College, his law degree from Harvard Law School, and a master of laws (taxation) degree from Georgetown University. He served in the Legal Department of the Federal Reserve Bank of New York before joining the Legal Department of the International Monetary Fund in 1963. Mr. Effros, who currently serves as Assistant General Counsel (Legislation) of the Fund, has participated in many staff missions involving legislative drafting and advice on general banking and central banking laws of member countries of the Fund. He is an Adjunct Professor of banking law at the American University Washington College of Law. He is also the author of a number of articles on banking and financial matters that have appeared in legal and other journals, and the editor of ***Emerging Financial Centers: Legal and Institutional Framework*** (International Monetary Fund, 1982), ***Current Legal Issues Affecting Central Banks*** (International Monetary Fund, vol. 1 (1992), vol. 2 (1994), and vol. 3 (1995)), and ***Payment Systems of the World*** (Oceana, 1994).

AUTHORS OF CHAPTERS

Ruth Ainslie graduated from Simmons College and received her law degree from Rutgers University in 1978. She joined the Legal Department of Bankers Trust Company in 1982, where she is a Managing Director and Counsel. Her primary responsibilities as legal adviser include the worldwide activities of the Bank in foreign exchange, swaps, and other derivatives transactions and related regulatory and legislative issues. Ms. Ainslie is a member of the Financial Markets Lawyers Committee (associated with the Foreign Exchange Committee of the Federal Reserve Bank of New York), an active participant in the International Swaps and Derivatives Association, and a member of the New York State Bar Association Committee on Commodities and Futures Law.



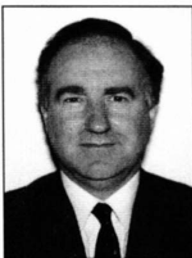
Tobias M.C. Asser received his law degree from Leyden University, the Netherlands, and his Ph.D. in private international law from Cambridge University, England. Before he joined the Legal Department of the International Bank for Reconstruction and Development (IBRD) in 1968, he was a practicing attorney in Amsterdam. Among the positions in which he served at the IBRD were those of Assistant General Counsel, Operations, and Assistant General Counsel, Finance. In 1987, Mr. Asser transferred from the IBRD to the Legal Department of the International Monetary Fund, where he serves as Assistant General Counsel. Mr. Asser is also an Adjunct Professor at Georgetown University Law Center in Washington, D.C., where he teaches international financial law.

Izak Atiyas received his B.A. in economics from Bogazici University in Istanbul in 1982 and his Ph.D. in economics from New York University. He joined the International Bank for Reconstruction and Development in 1987, and works in the Private Sector Development Department. He has worked primarily in the fields of industrial policy, industrial restructuring, financial sector reform, and political economy. He is coeditor, with Gerard Caprio, Jr. and James Hanson, of ***Financial Reform: Theory and Experience*** (Cambridge University Press, 1994). Currently, he is on leave from the IBRD and is teaching at Bilkent University in Ankara, Turkey.

James R. Barth received his B.S. in business administration from California State University at Sacramento and his Ph.D. in economics from Ohio State University. He has been a Professor of Economics at George Washington University, Visiting Scholar at the U.S. Congressional Budget Office, Visiting Scholar at the Federal Reserve Bank of Atlanta, and Associate Director of the Economics Program at the National Science Foundation. From 1987 to 1989, Professor Barth served as Chief Economist of the Federal Home Loan Bank Board, and later the Office of Thrift Supervision, which he left to become Lowder Eminent Scholar in Finance at Auburn University. Mr. Barth is the author and editor of several books on subjects concerning banking and financial services. In addition, he has lectured on various aspects of financial institution and deposit insurance issues.

Thomas C. Baxter, Jr. received his B.A. from the University of Rochester in 1976 and his J.D. from the Georgetown University Law Center in 1979. He joined the Federal Reserve Bank of New York as an attorney in 1980, following an appointment as a law assistant to the Appellate Division of the New York Supreme Court. Currently, he is General Counsel and Executive Vice President of the Bank. Previously, he served as Deputy General Counsel and Senior Vice President and was responsible for matters of civil litigation, enforcement, aspects of the payment system, and supervisory functions of the Legal Department staff. Mr. Baxter is a coauthor of *Wire Transfers: A Guide to U.S. and International Laws Governing Funds Transfers* (Probus, 1993), and has published several articles concerning the legal aspects of check collection, securities transfers, and electronic transfers of funds. He has also served as a lecturer on such subjects.

Raija Bettauer received her J.D. and LL.M. in international law from Helsinki University and a masters of comparative law in American practice from George Washington University. On a Fulbright Senior Scholarship in International Law, she studied at the law schools of Columbia University and Harvard University. Ms. Bettauer served with the Finnish Foreign Ministry before joining the Law Department of the Office of the Comptroller of the Currency (OCC) in Washington, D.C. There she served in a variety of functions, including Director of the Legislative and Regulatory Analysis Division. Currently, she is the Counselor for International Activities. Her responsibilities include directing and coordinating the OCC's legal counsel on supervisory issues relating to the foreign operations of American banks and the operations of foreign banks in the United States.



William Blair graduated from Oxford University and was called to the English Bar in 1972. His practice focuses on banking and financial law. He is a Senior Visiting Fellow to the Centre for Commercial Law Studies, Queen Mary and Westfield College, University of London, and Visiting Professor of Law at the London School of Economics. He became a Queen's Counsel in 1994. He is an editor of *The Encyclopedia of Banking Law* (Butterworths, 1982) and an author of *Banking and the Financial Services Act* (Butterworths, 1993). He sits as an Assistant Recorder (part-time judge).

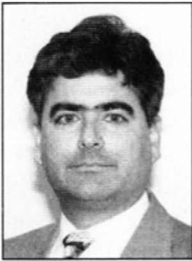
Carolyn J. Buck received a B.A. from the University of Minnesota and a J.D. from George Washington University. She served as the Assistant General Counsel for Litigation, and then as Deputy General Counsel for Operations in the Department of Housing and Urban Development. She joined the Office of Thrift Supervision (OTS) as Senior Deputy Chief Counsel in charge of overseeing the various enforcement and litigation divisions. Prior to becoming Chief Counsel for the OTS in November 1994, she served as the Acting Chief Counsel from December 1992.

Paolo Clarotti holds degrees in law and economics from the University of Paris. In 1959, he was appointed an official on the European Community Commission. He has served as a Principal Administrator in the Banking and Insurance Division and an Adviser to the Director of the Harmonization of Legislation. Since 1972, he has been head of the Banking and Financial Establishments Division. Mr. Clarotti has written extensively on banking and finance issues.

H. Rodgin Cohen received his B.A. and J.D. degrees from Harvard University. In 1970, he joined the New York City law firm of Sullivan & Cromwell, where he became a partner in 1977. He specializes in mergers and acquisitions and regulatory issues regarding the banking industry. Mr. Cohen is the author of numerous articles concerning commercial banking.

Daniel P. Cunningham received his B.A. from Princeton University and his J.D. from Harvard University. He joined the New York law firm of Cravath, Swaine & Moore in 1978 and became a partner in 1983. From 1986 to 1990, he was the firm's resident London partner. His area of expertise includes over-the-counter derivatives, securities offerings, project finance, joint ventures, and negotiated acquisitions. Since 1984, Mr. Cunningham has worked on documentation projects of the International Swaps and Derivatives Association, Inc. (ISDA). In addition, he has served as outside general counsel for ISDA since 1985 and has coordinated ISDA's surveys of the bankruptcy

laws of the G-10 countries in considering the enforceability of close-out netting under the 1987 and 1992 ISDA Master Agreements.

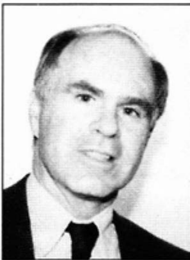


Guy David graduated with degrees in civil law and common law from the University of Ottawa. Currently, he is a partner with the Ottawa, Canada law firm of Gowling, Strathy & Henderson. He was Special Counsel to the Standing Committee on Finance of the Canadian Parliament during Canada's recent revision of its banking and financial sector legislation. Previously, he served as staff counsel to the Bank of Canada. He has published several articles in the fields of banking and electronics funds transfers and is coauthor of *The Annotated Bank Act* (Carswell, 1995).

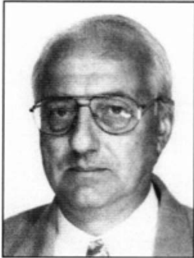
John P. Emert received a B.A. from Amherst College, an LL.B. from Stanford University, and an LL.M. from New York University School of Law. Prior to joining Citibank, N.A., as Vice President and Legal Counsel, he worked at Marine Midland Bank and the J. Henry Schroder Bank and Trust Company. He is responsible for legal issues relating to derivatives, foreign exchange, futures, and investment management.

MarySue Fisher received her B.A. from Vassar College and a J.D. from Boston University. She joined the Legal Department of the Federal Reserve Bank of New York in 1980. From 1987 to 1989, she worked in Fixed Income Securities at Bear, Stearns, and Co. Inc. She then worked from 1989 through 1990 with Credit Suisse Bank in Zurich. In 1991, she returned to the Federal Reserve Bank of New York where she held various positions through 1995, including Assistant Vice President in the Bank's Market Surveillance Function, Counsel and Vice President in the Legal Department, and Vice President on the Banking and Payment Systems Studies Staff in the Bank's Research Department. She is currently working on the launch of a new international financial company. Mrs. Fisher served as a member of the Study Groups on Cross-Border Securities Settlements and Delivery Versus Payment Systems of the Committee on Payments and Settlement Systems of the central banks of the Group of Ten countries.

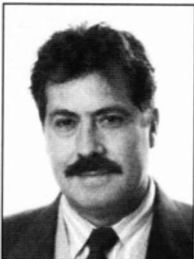
François P. Gianviti studied at the Sorbonne, the Paris School of Law, and New York University. He obtained a *licence ès lettres* from the Sorbonne in 1959, a *licence en droit* from the Paris School of Law in 1960, a *diplôme d'études supérieures de droit pénal et science criminelle* in 1961, a *diplôme d'études supérieures de droit privé* in 1962, and a *doctorat d'Etat en droit* in 1967. From 1967 to 1969, he was a Lecturer in Law, first at the Nancy School of Law and subsequently at the Caen School of Law. In 1969, Mr. Gianviti obtained the *agrégation de droit privé et science criminelle* of French universities and was appointed Professor of Law at the University of Besançon. From 1970 through 1974, he was seconded to the Legal Department of the International Monetary Fund, where he served as Counsellor and, subsequently, as Senior Counsellor. In 1974, he became Professor of Law at the University of Paris XII, where he taught civil and commercial law, banking and monetary law, and private international law. He served as Dean of its School of Law from 1979 through 1985. In 1986, Mr. Gianviti became Director of the Legal Department and, in 1987, General Counsel of the International Monetary Fund. He is a member of the Committee on International Monetary Law of the International Law Association and has published a book on property and many articles on aspects of French and international law.



Ian H. Giddy received his Ph.D. from the University of Michigan. He has taught at the Wharton School of the University of Pennsylvania, Columbia University, the University of Michigan, the University of Chicago, and Georgetown University. Professor Giddy served in the Office of the Comptroller of the Currency and at the Board of Governors of the Federal Reserve System. He has acted as a consultant to a number of multinational corporations and financial institutions. He served as Director of the International Product Group at Drexel Burnham Lambert. He currently teaches at the New York University Stern School of Business and is a Senior Fellow at the NYU Salomon Center. In addition to numerous articles that he has published, Professor Giddy is the coauthor of *The International Money Market* (Prentice Hall International, 2d. ed., 1994) and *Cases in International Finance* (Addison-Wesley Publishing Co., 1993), and the coeditor of *International Finance Handbook* (Wiley, 1983).

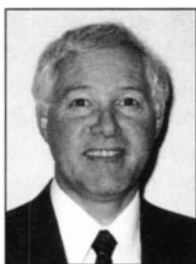


Mario Giovanoli received degrees as a *Licencié ès sciences politiques* and a Doctor of Law from the University of Lausanne. He then spent two years as an assistant at the Law Faculty of the University of Mainz before joining the Bank for International Settlements (Basle, Switzerland), which he currently serves as Legal Adviser and Manager. Since 1987, he has also been Professor at the Law Faculty of the University of Lausanne, where he lectures on such topics as banking regulation, bank operations, central banks, money and payments systems, financial markets, and European banking and monetary law. He has also published a number of papers on these topics and is the author of a major comparative study, as well as several articles, on the law of financial leasing. He is Chairman of the Monetary Law Committee of the International Law Association (MOCOMILA).



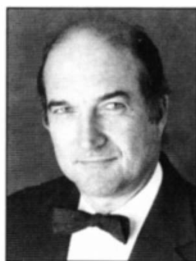
Jorge Guardia graduated with degrees in law and economics from the University of Costa Rica and received an LL.M. from Harvard Law School. From 1972 to 1980, he worked in the Legal Department of the International Monetary Fund. He returned to private practice in Costa Rica. From 1990 to 1993, he was the President of the Central Bank of Costa Rica. In October 1993, he returned to the Fund as a consultant, and, in June 1996, he once again returned to private practice in Costa Rica.

William E. Holder received his LL.B. and his B.A. from the University of Melbourne. He subsequently earned an LL.M. from Yale University and a Diploma from the Hague Academy of International Law. He has served as a Tutor in Law at the University of Melbourne, a Professor of Law at the University of Mississippi, a Reader in Law at the Australian National University, and as an advisor on international law for the Australian Department of Foreign Affairs. Mr. Holder joined the International Monetary Fund in 1976 and has served as Deputy General Counsel since 1986. He is the author of many articles on international law subjects.



James V. Houpt holds a masters of business administration degree from George Washington University. Since 1973, he has worked for the Board of Governors of the Federal Reserve System. He currently serves as Assistant Director of the Division of Banking Supervision and Regulation. In this post, he oversees the Financial Analysis and Policy Implementation Groups. In recent years, Mr. Houpt has been actively involved in domestic and international efforts to develop supervisory proposals for measuring interest rate and other market risks.

Cynthia C. Lichtenstein earned her undergraduate degree from Radcliffe College, a J.D. from Yale Law School, and an LL.M. in comparative law from the University of Chicago Law School. Since 1971, she has been a Professor of Law at Boston College Law School, where she specializes in international economic law. She also served as a special consultant to the New York law firm of Milbank, Tweed, Hadley & McCloy from 1985 to 1994. Ms. Lichtenstein has served as President of the American Branch of the International Law Association (ILA)(1986–92), past Vice President and current Honorary Vice President of the American Society of International Law, member of the ILA's International Monetary Law Committee, and as Rapporteur of the ILA's Committee on International Securities Regulation, of which she is presently Chair. She has spoken and written extensively on a broad range of international financial matters, including U.S. and foreign banking.



Simon M. Lorne is a 1967 Phi Beta Kappa graduate of Occidental College. He earned his J.D. degree, magna cum laude, at the University of Michigan Law School in 1970. He is a Managing Director of Salomon Brothers Inc., Director of Internal Audit of Salomon Inc., and a senior member of the Salomon control team. Formerly he served as General Counsel of the United States Securities and Exchange Commission, a position to which he was appointed under Chairman Arthur Levitt from 1993 to 1996. Prior to assuming that position, Mr. Lorne had been a partner since 1972 in the Los Angeles law firm of Munger, Tolles & Olson, where his practice was concentrated in the areas of corporate and securities law. He is a frequent panelist and lecturer, is the author of a number of articles in law reviews and other periodicals, and is the author of the multivolume treatise, ***Acquisitions and Mergers:***

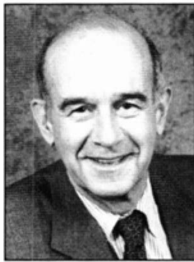
Negotiated and Contested Transactions (Clark Boardman Callaghan Securities Law Series).

Fé Morales Marks received her B.A. from Barnard College and a J.D. from Columbia University. From 1979 to 1991, she was in private practice representing clients in all aspects of the financing of housing, health care, and community development projects. Beginning in 1991, she was Superintendent of the District of Columbia Office of Banking and Financial Institutions. In 1993, she became Deputy Assistant Secretary (Financial Institutions Policy) of the U.S. Department of the Treasury. She is responsible for formulating financial institutions policy, monitoring regulation of financial intermediaries, and interacting with Congress, the industry, and regulators on financial institutions policy matters.

J. Virgil Mattingly, Jr. received his undergraduate and law degrees from George Washington University. After four years of service as an attorney for the U.S. Army Judge Advocate General Corps, he joined the Board of Governors of the Federal Reserve System in 1974. He currently serves as General Counsel. Under his direction, the Legal Division is responsible for providing legal counsel to the Board on supervisory, regulatory, monetary, legislative, litigation, or other matters arising under the Board's jurisdiction, as well as on issues relating to the Board's internal operations.

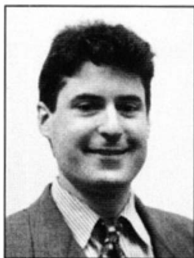
Jacques Milleret studied public law at the University of Paris, as well as law and political science at l'Institut d'Etudes Politiques de Paris. He has worked at the Banque de France for the past 14 years. Currently, he is a member of the cabinet of the Legal Department, which is a group of advisers of the Director of the Legal Department. He participated in the drafting of the Banking Act of 1984 and the Banking Act of August 4, 1993, which changed the status of the Banque de France.

Reinhard H. Munzberg studied law at the Universities of Erlangen and Würzburg, where he received his Doctorate in Law. From 1972 to 1977, he worked in the Ministry of Finance, where, by 1977, he was named Head of the Minister's Office. The following year, he became Head of the Minister's Office, Ministry for Economic Cooperation, where he remained until becoming an Executive Director at the World Bank in 1981. In 1985, Mr. Munzberg began work with the International Monetary Fund as a consultant to the Administration Department. In 1986, he was appointed Assistant General Counsel of the Legal Department. After serving as Deputy General Counsel from 1988 to 1996, he was appointed Secretary of the International Monetary Fund. Mr. Munzberg is the author of various articles on international legal issues.



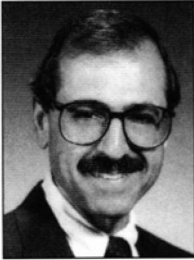
Andre Newburg graduated with a B.A. from Harvard College and with an LL.B. from Harvard Law School. In 1952, he began working for the New York law firm of Cleary, Gottlieb, Steen & Hamilton. He represented the firm in Paris and Brussels from 1956 to 1964 and again in 1975–76, and in Hong Kong in 1980. From 1991 until July 31, 1995, he served as the first General Counsel of the European Bank for Reconstruction and Development, of which he is now a Senior Advisor.

Kathleen M. O'Day graduated from Assumption College in Worcester, Massachusetts, and received her J.D. from Boston College Law School. Ms. O'Day currently serves as Associate General Counsel in the Legal Division of the Board of Governors of the Federal Reserve System. Her areas of responsibility include legislative and regulatory matters relating to foreign banks operating in the United States and U.S. banks operating abroad and issues arising in connection with international trade agreements and international financial institutions.



Keith A. Palzer received his B.A. from the State University of New York at Binghamton and his J.D. from Northwestern University. In 1988, he joined the U.S. Department of the Treasury, where he served as an Honors Attorney, a Special Assistant U.S. Attorney, and Attorney-Advisor for International Affairs, specializing in international financial regulatory issues and financial services negotiations with foreign countries.

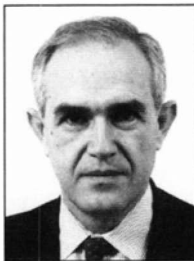
He worked on the North American Free Trade Agreement, the Uruguay Round of GATT negotiations, and the 1991 financial reform effort in Congress. Mr. Palzer served as Legal Counsel to the Swaziland Ministry of Finance in 1993. Mr. Palzer is associated with the New York City office of Mayer, Brown & Platt, where he represents financial institutions in transnational operations.



Ernest Patrikis received his law degree from Cornell University. He joined the Federal Reserve Bank of New York in 1968, serving in several positions, including Assistant Secretary of the Bank and Executive Vice President and General Counsel. He has served as the Deputy General Counsel of the Federal Open Market Committee. In June 1995, Mr. Patrikis was appointed First Vice President of the Bank. He has served as a U.S. delegate to the Working Group on International Payments of the United Nations Commission on International Trade Law. He is also an advisor to the (U.S.) National Conference of Commissioners on Uniform State Laws and served as the first Chairman of the New York State Bar Association's Committee on International Banking, Securities and Financial Transactions. Mr. Patrikis has lectured and written on the supervision and regulation of U.S. and non-U.S. banks, reserve requirements, payments laws, and sovereign immunity.

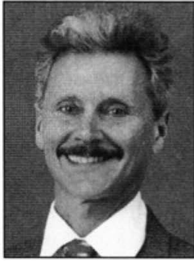
Larry Promisel completed undergraduate work at Cornell University and the London School of Economics before receiving his graduate degrees in economics from Yale University. He then joined the Board of Governors of the Federal Reserve System. Currently, he is a Senior Associate Director in the Division of International Finance and is responsible for international banking, financial markets, and U.S. international transactions. He has served as Chairman of the G-10 central bank working group that prepared a report on recent developments in international interbank relations (1992) and has been a frequent participant at meetings sponsored by both the Bank for International Settlements and the Organization for Economic Cooperation and Development. He is the author of several articles on monetary policy and economic aspects of foreign economies.

Kenneth Raisler graduated from Yale University and New York University School of Law. After serving as a law clerk in the U.S. District Court for the Southern District of New York, he was appointed Assistant United States Attorney for the District of Columbia from 1977 to 1982. From 1983 to 1987, he was General Counsel of the Commodity Futures Trading Commission. He has served as the Chairman of the Association of the Bar of the City of New York Committee on Futures Regulation. He is currently a partner in the New York law firm of Sullivan & Cromwell, where he is cohead of its Commodities, Futures, and Derivatives Group. He was a member of the Working Group of the Group of Thirty Derivatives Project, and currently serves on the Board of Directors of the Futures Industry Association.

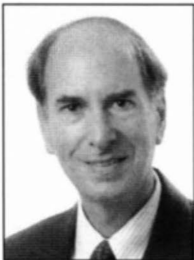


Andrés Rigo earned a law degree from the University of Madrid and a Ph.D. from the University of Cambridge. He served as an Associate Professor of International Law at the Universidad Autonoma de Madrid and as an adviser to the Government of Venezuela on the law of the sea. In 1973, he joined the International Bank for Reconstruction and Development as an attorney. As Chief Counsel, he headed the Africa Division of the Legal Department. Mr. Rigo was appointed Assistant General Counsel, Operations, in 1992 and Deputy General Counsel, Operations, in November 1994.

Elizabeth Roberts received her bachelor's degree from Sweet Briar College and a master's degree from the American Graduate School of International Management. She also studied at the University of Munich. In 1980, she joined the Division of Banking Supervision and Regulation at the Board of Governors of the Federal Reserve System. She has spent numerous years following European banks that have U.S. operations. Since 1993, she has been Manager of the International Policy Section. Prior to joining the Federal Reserve, she was in the International Division of First Union National Bank in Charlotte, North Carolina. Currently, Ms. Roberts is on a two-year leave of absence from the Federal Reserve to serve as a member of the Secretariat of the Basle Committee on Banking Supervision.



Thomas A. Rose graduated from Villanova University School of Law. He is an expert in bankruptcy law and loan workouts. He is currently Deputy General Counsel of the Liquidation Branch of the Legal Division of the Federal Deposit Insurance Corporation (FDIC). In that capacity, he oversees the legal activities related to closed financial institutions. Mr. Rose also serves as the Dispute Resolution Specialist at the FDIC. He is a former Director of the American Bankruptcy Institute. He speaks frequently on issues concerning failed banks and thrifts.



Henry N. Schiffman received a B.A. from Cornell University and a J.D. from New York University. He was a Fulbright Fellow at the Faculty of Law and Economics of the University of Paris. His legal career involved work at both the Board of Governors of the Federal Reserve System in Washington, D.C. and the Organization for Economic Cooperation and Development Secretariat in Paris. He is currently a consultant at the International Monetary Fund, where he provides technical assistance on central bank and commercial bank law, bankruptcy law, and foreign investment law.

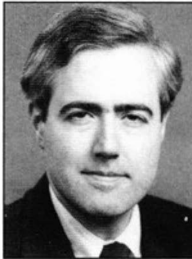
Tony Shea graduated with a B.A. and an LL.B. from Canterbury University in New Zealand, before taking his D.Phil. at Oxford University, England (Oriel College). He then moved to The City University in London, and became Head of the Law Department, and Professor of Law (simultaneously serving, for a period, as Senior Research Fellow at Queen Mary College, University of London). In 1988, he joined the international law firm Clifford Chance, and became head of the International Financial Regulation Unit. He worked extensively in Eastern Europe and the Commonwealth of Independent States for the World Bank and other organizations. Having left Clifford Chance in 1995, he is now legal advisor in the Kyrgyz Republic to the Agency for Reorganization and Liquidation of Enterprises (to be transformed into the Directorate for Foreign Investment). He drafted the Kyrgyz bankruptcy laws and is now helping to revise them. He was an adviser to the U.K. Government "Jack Committee" on Banking Law and Practice; in addition, he is coauthor of books on banking law, and has written many articles on banking and financial law.

René Smits studied law and sociology at the Free University in Amsterdam, specializing in European Community law and economics. In 1978, he joined the Nederlandsche Bank, which is the central bank of the Netherlands. After serving as chief of one of the banking supervision departments, he was appointed General Counsel and head of the Nederlandsche Bank's Legal Department. His activities have included assisting in preparation of EC banking supervisory rules and their implementation in the Netherlands, international negotiations, and legal work concerning international monetary affairs. Mr. Smits is the author of articles on international organizations, EC monetary and banking law, and the legal aspects of development policy, and is also an editor of a commentary on EC banking regulations. He is a member of the Committee on International Monetary Law of the International Law Association.

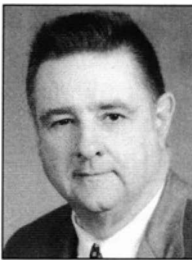
Robert Sparve received an LL.M. from Stockholm University. In 1973, after serving as an attorney in private practice, he joined the Sveriges Riksbank, the Swedish central bank. He currently serves as Director, Head of Secretariat of the Board, and Chief Legal Counselor. Mr. Sparve serves as an expert in government committees on economic policy and other financial issues.

Jennifer A. Sullivan is a graduate of Brandeis University and Harvard Law School. She worked as Legal Adviser at the U.S. Securities and Exchange Commission and then entered private practice with the New York law firm of White & Case. In 1987, she joined the International Finance Corporation as an attorney. She has served as Senior Counsel, Principal Counsel, Chief Counsel, and, since April 1995, as Deputy General Counsel.

Bertold Wahlig studied at the law schools of the Universities of Mainz and Freiburg, Germany, receiving his law degree after fulfilling the practical requirements of the degree by practicing with various courts, offices, and law firms. In 1962, he joined the legal department of the Deutsche Bundesbank, which is the German central bank. He now serves as General Counsel. In addition to his immediate work, Mr. Wahlig has attended United Nations Commission on International Trade Law (UNCITRAL) meetings and participated in UNCITRAL working groups as special adviser for the Ministry of Justice of the Federal Republic of Germany. Since 1985, he has been a member of the Committee on International Monetary Law of the International Law Association. Mr. Wahlig has published a number of articles concerning issues of monetary law.



Mark J. Welshimer received his B.A. from Harvard College and his J.D. from Harvard Law School. In 1976, he entered private practice with the New York law firm of Sullivan & Cromwell, where he has been a partner since 1983. His practice focuses on banking and securities law matters, particularly on securitizations. Mr. Welshimer has represented clients on many public and private securitizations of new products, including automobile receivables, commercial mortgage loans, and distressed assets.



Roger M. Whelan received his undergraduate degree from Georgetown University (cum laude), 1959, and his law degree from Georgetown University Law Center (J.D., 1962). He served as U.S. Bankruptcy Judge for the District of Columbia from 1972 to 1983. He is currently Senior Counsel at the Washington, D.C., law firm of Shaw, Pittman, Potts & Trowbridge, and is a Distinguished Lecturer at Catholic University Law School. In addition, he is also Legislative Chairman and Executive Committee Member of the American Bankruptcy Institute and serves on the Executive Committee of the Bankruptcy Section of the Federal Bar Association. He is the author of numerous works on bankruptcy law.

COMMENTATORS

William E. Alexander received his B.Com. from the University of Toronto and his A.M. and Ph.D. from the University of Michigan. He was on the staff of the Bank of Canada, where he last served as an Adviser to the Governor on international monetary affairs, for a number of years. At various points in his career, Mr. Alexander was seconded as Director of Research for the Institute of International Finance, as a senior member of the Economic Council of Canada, and as an Alternate Director of the Export Development Corporation of Canada. In 1992, he joined the Monetary and Exchange Affairs Department of the International Monetary Fund, where he currently serves as Division Chief of the Monetary and Exchange Policy Analysis Division.

John S. Baerst received his B.A. from St. Anselm College and his law degree from Columbia University Law School. He joined the New York City law firm of Simpson, Thatcher & Bartlett in 1972. He joined Barclays Bank PLC in 1980 as General Counsel. After serving as Senior Vice President and General Counsel of the U.S. operations of the Bank, in August 1994, he became President and Chief Executive Officer of Barclays Bank of New York, N.A. In January 1996, he was appointed Professor of Banking Law and Director of the Morin Center for Banking and Financial Law Studies at Boston University School of Law. He is Chairman of the Subcommittee on International Banking of the American Bar Association's Banking Committee.

William M. Berenson holds a B.A. from Dartmouth College, an M.A. and a Ph.D. in political science from Vanderbilt University, and a J.D. from Boston University. During 1972 and 1973, he did research in Uruguay under a Ford Foundation Foreign Area Fellowship. He has worked on a broad range of issues in both the private and public sectors as a litigator and legal adviser. Currently, Mr. Berenson is the Acting Assistant Secretary for Legal Affairs and Director of the Department of General Legal Services for the General Secretariat of the Organization of American States and is an Adjunct Professor at American University's Washington College of Law. He has also served as the Chairman of the International Development and Investment Committee of the Federal Bar Association.

Raija Bettauer's biography appears with the main biographies.

Raj Bhala received his undergraduate degree from Duke University, a master of science in economics from the London School of Economics, a master of science in management from Oxford University, and a J.D. from Harvard Law School. He began his legal career in 1989 as an attorney in the Legal Department of the Federal Reserve Bank of New York. In 1993,

he became an Assistant Professor of Law at the College of William and Mary, and an Associate Professor in 1996, where he lectures on international banking and securities law and international commercial law.

Michael Bradfield received his B.A. from Union College and his master's degree in international affairs and a J.D. from Columbia University. He began his legal career at the U.S. Department of the Treasury, where he served in various positions, including Assistant General Counsel for International Affairs. He entered private practice in 1975 by joining the firm of Cole, Corette & Bradfield, where he specialized in international finance and trade law. From 1981 to 1989, he served as the General Counsel of the Board of Governors of the Federal Reserve System. He joined the Washington office of Jones, Day, Reavis & Pogue in 1989 and is a partner, as well as cochair, of the Financial Institutions/Institutional Lending Section of the firm's Corporate Group.

Deborah K. Burand received a joint degree combining a law degree and a master of science in foreign service degree from Georgetown University. Upon graduation, she joined the New York law firm of Shearman & Sterling, where she focused on cross-border financing and provided *pro bono* advice on the use of debt-for-nature and debt-for-development swaps to nonprofit organizations. She then worked as the Conservation Finance Coordinator for Conservation International, a nonprofit organization. In 1989, she joined the International Banking Section of the Legal Division of the Board of Governors of the Federal Reserve System, where she worked until 1994 as a senior attorney. While at the Federal Reserve Board, she was awarded an International Affairs Fellowship from the Council on Foreign Relations to study the role of central banks in Eastern Europe and the countries of the former Soviet Union. In late 1994, she rejoined Shearman & Sterling, where her practice includes bank regulatory matters, project finance, and other cross-border financial transactions.

V. Gerard Comizio earned his B.A. from Fordham University, his J.D. from Pace University Law School, and his LL.M. in securities regulation from Georgetown University Law Center. Mr. Comizio is currently the managing partner of the Washington office of Thacher, Proffitt & Wood, a New York-based law firm. Prior to joining the firm, Mr. Comizio was, for a number of years, Deputy Chief Counsel of the Office of Thrift Supervision (and its predecessor, the Federal Home Loan Bank Board), and Director of the agency's Corporate and Securities Division. From 1981 to 1984, Mr. Comizio was an attorney with the Division of Corporation Finance at the Securities and Exchange Commission, acting as Senior Attorney and Assistant Branch Chief in that division from 1983 to 1984. In addition to his work, he is the author and coauthor of numerous articles on banking,

securities, and financial institution matters. Mr. Comizio is currently an Adjunct Professor of banking law at the American University Washington College of Law.

John P. Danforth received his master's degree and doctorate in economics from Northwestern University. He served as Senior Vice President and Director of Research at the Federal Reserve Bank of Minneapolis and was Principal and Managing Director of Golembe Associates, Inc. He is currently Managing Director with The Secura Group, where he provides consulting and financial advisory services for banks and savings associations. He is an expert on the operation of financial markets, the valuation of financial institutions and assets, and the competitive impacts of bank mergers and acquisitions.

Melanie L. Fein received a B.A. degree from Earlham College and a J.D. from Catholic University Law School. She served as a Senior Counsel to the Board of Governors of the Federal Reserve System before joining the Washington, D.C. law firm of Arnold & Porter, where she is a partner. Her practice encompasses a wide variety of legal, regulatory, and legislative issues affecting domestic and foreign banks, bank holding companies, and other financial institutions. In addition to having taught banking law for two semesters at Yale Law School, she is the author of several publications on that subject.

Ernesto V. Feldman (deceased) received his degree in economics from the University of Buenos Aires and a doctorate from Nuffield College, University of Oxford. From 1971 to 1985, he worked at the Central Bank of Argentina. He served as Manager of the Department of Banking Supervision and Manager of the Economic Research Department. From 1985 to 1986, he was a Member of the Board of Directors of the Central Bank of Argentina. From 1987 to 1990, he was an Executive Director at the International Monetary Fund for Argentina and five other countries of the Southern Cone. From 1991 to 1996, he was a consultant with the Fund, most recently in the Monetary and Exchange Affairs Department. He wrote several articles on the banking systems of Latin America.

David Folkerts-Landau received his B.A. in economics from Harvard University and his Ph.D. in economics from Princeton University. He was an Assistant Professor of Financial Economics at the University of Chicago's Graduate School of Business. In 1980, he joined the International Monetary Fund as an Economist in the Financial Studies Division, where he has also served as Senior Economist and Deputy Chief. He is currently Assistant Director and Division Chief of the Capital Markets and Financial Studies Division. He is an expert on international capital markets and has written numerous articles on the subject.

Larry Gurwin received a bachelor's degree in journalism from New York University and spent several years as a financial journalist for *Institutional Investor* and other publications. He is the coauthor (with Peter Truell) of *False Profits: The Inside Story of BCCI, the World's Most Corrupt Empire* (Houghton Mifflin Company, 1992). He is also the author of *The Calvi Affair,* on Italy's Banco Ambrosiano scandal (Macmillan London Ltd., 1983). From October 1990 to May 1995, he was a financial investigator. He then returned to journalism as an investigative reporter for *Time* magazine, based in Brussels, Belgium.

Andrew T. Hook received an M.B.A. from Columbia University and a Ph.D. in economics from New York University. In 1977, he joined the Federal Reserve Bank of New York, where he last served on the Payments Systems Staff. Thereafter, he served as a consultant specializing in payments system work in the Monetary and Exchange Department of the International Monetary Fund. He is the author of various publications on payments systems in Eastern Europe, the former Soviet Union, and countries in Africa and South America.

Sydney J. Key received her B.A., M.A., and Ph.D. in economics from Harvard University. She is currently on the staff of the Board of Governors of the Federal Reserve System in the International Finance Division, which she joined in 1971. In the 103d U.S. Congress (1993–94), she was Staff Director for the Subcommittee on International Development, Finance, Trade, and Monetary Policy of the Committee on Banking, Finance, and Urban Affairs in the House of Representatives. In 1990 and 1991, she served as a national expert in the European Commission's DG-XV, the directorate general responsible for financial institutions. Dr. Key is a Lecturer at the Morin Center for Banking and Financial Law Studies at Boston University School of Law, and a Senior Visiting Fellow at the Centre for Commercial Law Studies at Queen Mary and Westfield College, University of London. She also lectures annually at the London School of Economics, where she was an Academic Visitor in the Department of Accounting and Finance. Dr. Key has published numerous articles and papers, including *International Trade in Banking Services: A Conceptual Framework,* which she coauthored with Hal. S. Scott (Group of Thirty, 1991).

Boris Kozolchyk received a Ph.D. in civil law from his native Cuba, an LL.B. from the University of Miami College of Law, and an LL.M. and an S.J.D. from the University of Michigan School of Law. He is the former President of the International Academy of Commercial and Consumer Law. He currently is President and Director of the National Law Center for Inter-American Free Trade, a U.S. delegate to the United Nations Commission on International Trade Law, and a Representative of the U.S.

Council on International Banking to the International Chamber of Commerce Working Group for the Revision of Uniform Customs and Practices for Documentary Credits. Dr. Kozolchyk teaches courses in commercial and international trade law at the University of Arizona College of Law. He is an author and speaker on commercial and international law issues, specializing in letters of credit and other instruments of commerce.

Rosa Maria Lastra received a law degree and an M.A. in law and economics of the EEC from Valladolid University, an LL.M. degree from Harvard Law School (where she was a Fulbright Fellow), and a Ph.D. from Madrid University, after completion of research at the London School of Economics. Starting in 1992, she worked for two years as a consultant in banking and central banking for the Legal Department of the International Monetary Fund. In September 1993, she was appointed Director of the International Finance and Business Program in the School of International and Public Affairs in Columbia University, where she held the position of Assistant Professor in International Banking. Ms. Lastra was also an Affiliated Scholar of the Center for the Study of Central Banks at New York University Law School. Currently, she is associated with the Centre for Commercial Law Studies of Queen Mary and Westfield College, London. In addition, she is the author of articles and papers on banking and monetary matters.

Natalie G. Lichtenstein is Chief Counsel, East Asia & Pacific, in the World Bank's Legal Department. She has spent more than 15 years as counsel for World Bank lending operations in numerous countries, including China and Vietnam. She is currently chief of the Legal Department division, which handles the Bank's legal work in countries extending geographically from Korea to Burma. Ms. Lichtenstein received her B.A. (summa cum laude) in East Asian Studies from Radcliffe College and Harvard University, and a J.D. from Harvard Law School. She was an Attorney-Adviser in the International Affairs section of the General Counsel's Office at the U.S. Department of Treasury from 1978 to 1980. She taught Chinese law as an Adjunct Professor at the Georgetown University Law Center from 1982 to 1986 and has written occasional articles and papers on Chinese and Vietnamese law.

Charles W. Mooney, Jr. received his B.A. from the University of Oklahoma and his J.D. from Harvard Law School. From 1972 to 1981, he was with the Oklahoma City law firm of Crowe & Dunlevy. Until 1986, he was a partner in the New York law firm of Shearman & Sterling, where he specialized in private financing transactions and banking law. In 1988, he was a Visiting Scholar with the Bank of Japan in Tokyo. He is currently a Professor of Law at the University of Pennsylvania Law

School. Professor Mooney serves as a Reporter for the Drafting Committee on the Revision of Uniform Commercial Code Article 9 (Secured Transactions). He was a representative of the U.S. Department of State for the Unification of Private Law (UNIDROIT) Convention on International Financial Leasing, and currently is a representative for the UNIDROIT Study Committee on the secured financing of international mobile equipment. He is the author of books, chapters, and articles in the commercial law field.

Marilyn L. Muench received a B.A. in political science from Whitman College, an M.A. from Duke University, and a J.D. from Harvard Law School. Before attending law school, she was a Foreign Service officer with the U.S. Department of State. Upon graduation from law school, she entered into private practice at the Washington, D.C. law firm of Sutherland, Asbill & Brennan. She later worked at the U.S. Department of the Treasury in the Office of Foreign Assets Control, where she served as Chief of Licensing and then Chief Counsel. She is currently Deputy Assistant General Counsel for International Affairs at the Department of the Treasury.

Russell L. Munk is a graduate of Harvard College and Harvard Law School. He spent two years with a law firm in Tokyo and five years with the Office of the General Counsel of the Asian Development Bank in the Philippines. Since 1975, he has been the Assistant General Counsel for International Affairs of the U.S. Treasury Department.

Sandra M. Rocks received her undergraduate degree from Susquehanna University and a J.D. from Columbia University. She was a law clerk to a New Jersey Supreme Court Justice. Currently, she is special counsel at the New York law firm of Cleary, Gottlieb, Steen & Hamilton, where she specializes in securitization, secured transactions, and bankruptcy law. In 1991, the U.S. Securities and Exchange Commission named her as a member of its Market Transactions Advisory Committee. She also serves as chair of the bankruptcy subcommittee for that group. Since 1992, she has been cochair of the Subcommittee on Investment Securities of the Uniform Commercial Code Committee of the Business Law Section of the American Bar Association and chair of the Task Force on Proposed Treasury Regulations Governing Book-Entry Securities.

ISBN 1-55775-503-5